February 1959

THE CANADIAN CHARTERED ACCOUNTANT

Role of Factoring in Business

Valuation of Goodwill

Control of Warehouse Costs

Profit Sharing: Key to Industrial Peace

The Corporate Structure in Estate Planning

ACCOUNTING RESEARCH: British Accounting and Auditing Practices

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THE CANADIAN
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IN THIS ISSUE

S. H. LEVY (page 113)

Year by year the majority of businesses grow more complex and competitive, and the problem of meeting new financial requirements increases in intensity. Inevitably, the role of credit has become more important and plays a larger part in averting business economic distress. In Sidney H. Levy's article "The Role of Factoring in Business", the author deals with some of the benefits which factoring can offer as a method of financing and outlines how funds advanced against accounts receivable can put sales opportunities within a company's grasp.

Mr. Levy draws his observations from a long association in this particular field of business financing. He joined Canadian Factors Corporation Limited, Montreal, nearly 25 years ago and in 1937 was elected vice-president of the company. In 1957 he became its president. We believe this article will be of interest and value to all accountants at a time when they are being called upon more frequently than ever before to guide and advise their clients on a great variety of problems.

A. J. LITTLE, F.C.A. (page 107)

"A company may have substantial sales volume, good reputation, and product acceptance by the market", says Arthur J. Little, "and yet, for some reason, be unable to make a profit. Goodwill is surely present but in the circumstances is not apt to be valued highly by a prospective purchaser." Assessing this situation in his article "The Valuation of Goodwill", Mr. Little deals with a number of related questions concerning goodwill which must often come up in the minds of thoughtful businessmen, such as: What is goodwill? Is it tangible? Has it a saleable value? He concludes with six general observations in an attempt to explain a complex subject which covers a wide range of opinions and viewpoints.

Mr. Little is a partner in the firm of Clarkson, Gordon & Company, Toronto, with whom he has been associated since 1935. He is a member of the executive, Board of Governors, Canadian Tax Foundation and the taxation committee of the Toronto Board of Trade. Active in community, charitable and educational affairs for many years, he is a member of the boards of two Ontario colleges and the Business School Committee, University of Western Ontario. He also serves as vice-president of the Ontario Council, St. John Ambulance and is a member of the Board, Toronto Unit, Canadian Cancer Society. He is a past president of the Toronto Board of Trade.

T. J. DIGGORY (page 125)

In "Control of Warehouse Costs", Thomas J. Diggory advances the theory that in a wholesale or distributing business the proper treatment of warehouse costs is of critical importance. Inadequate control can result in considerable wastage and important losses in profit can be suffered. The author considers some of the typical expenses encountered in a warehousing operation, how they can be classified and the various methods whereby costs can be recovered in the selling prices of the products handled.

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Mr. Diggory was associated for several years after World War II with a number of British firms and, on coming to Canada, joined the Minnesota Mining and Manufacturing Company of Canada Limited of London, Ontario. He subsequently obtained a diploma in Business Administration at the University of Western Ontario and in 1953 joined Kelvinator of Canada Limited as a systems and procedures analyst. A year and a half later he was appointed a consultant to the management controls department of Peat, Marwick, Mitchell & Company, Toronto and is currently a manager in the department. He is an associate member of the Chartered Institute of Secretaries, the Association of Certified and Corporate Accountants, the Institute of Cost and Works Accountants, and the British Institute of Management.

D. D. W. IRWIN, C.A. (page 129)

Readers interested in a thought provoking and frank discussion on Canadian labour-management relations and how the partnership may be improved will want to turn to Douglas W. Irwin's "Profit Sharing: Key to Industrial Peace". Mr. Irwin is concerned about the Soviet Union's growing threat to world markets and the "possibility of a spate of Russian products untrammelled by considerations of price displacing our products in the uncommitted markets of the world". He is also concerned with the friction which prevails between capital and labour with its tremendous costs to both. In proposing a method of dealing with these problems, Mr. Irwin presents a strong case for profit sharing. In regard to world trade, he claims it can play a vital part in decreasing unit cost and increasing productivity. And he be-

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lieves that, if properly understood and practised, it can be of definite help in improving labour-management relations, avoiding political pressure for business regulations, and keeping down the cost of social security measures.

A partner in Fred Page Higgins & Company, Toronto, since 1957, Mr. Irwin's interests include studies of municipal problems, particularly those of annexation and amalgamation and financial aspects of labour-management relations. For the past six years he has been a special lecturer on financial management at the School of Business Administration, University of Toronto. He is a member of the Institute of Chartered Accountants of Ontario and the Council of Profit Sharing Industries and has been a frequent contributor to *The Canadian Chartered Accountant.*

C. P. GLOVER and C. W. J. HARPER (page 120)

Estate planning is a comparatively new function in Canadian business, stimulated in the last 30 years by increasing income and death taxes, but it is only since the end of World War II and particularly during the past seven or eight years that considerably more thought has been given to the way in which the corporate structure can be used. There are many characteristics of a corporation which make it a valuable instrument in the planning of estates, and in "The Corporate Structure in Estate Planning", Charles P. Glover and William J. Harper show how the use of the corporation can be applied to freeze an estate, transfer ownership and/or establish it in the hands of future management. According to the authors this opens up an ever expanding field for accountants and lawyers with imagination who are prepared to do some constructive thinking.

Mr. Glover is assistant superintendent of agencies attached to the Estate Service Division of The Canada Life Assurance Company and a graduate of Osgoode Hall Law School. He served for two years in the Dominion Succession Duty office, Toronto, before joining the company in 1943.

Mr. Harper is a graduate in Commerce and Finance of the University of Toronto and currently senior analyst of the Estate Division of Canada Life. He has had considerable experience in this field since 1950 when he became associated with the company.

EDITORIAL (page 105)

Of those sitting for their chartered accountancy examinations last October, 586 successful students passed their finals and will be admitted in the coming months to membership in their respective Provincial Institutes. Total Canadian Institute membership will near the 8,600 mark of whom an estimated 52% are in public practice. The demands on chartered accountants are increasing rapidly. The scope for their services is widening. More and more they are asked for advice and required to give judgment. In "Satisfaction of a Public Accounting Career", John R. Church points out what a stimulating experience it is to be connected with a profession which is growing so rapidly and which must plan ahead to keep pace with new developments and new thinking in business management. His editorial shows how the professional public accountant is closely identified with and deeply conscious of these demands on his services.

Mr. Church is a partner in the Montreal office of Price Waterhouse

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& Company and a member of the Canadian Institute's Committee on Accounting and Auditing Research. He has devoted much time to his chosen profession since being admitted to the Institute of Chartered Accountants of Ontario in 1930. He was elected a Fellow of the Institute in 1950. He is also a member of the Institutes of Chartered Accountants of British Columbia and Quebec and served as president and member of Council respectively in both provinces. From 1948 to 1950 he was a member of the Executive Committee of the Canadian Institute and is a former governor of the Canadian Tax Foundation. During the early years of World War II he was on loan to the Foreign Exchange Control Board at Ottawa.

NOTES AND COMMENTS

E. J. Howson, F.C.A.

E. Jay Howson, who was president of the Dominion Association of Chartered Accountants (as it then was) in 1948-49, died on December 19 in his home city of Toronto. Mr. Howson was a partner of Thorne, Mulholland, Howson and McPherson and had a distinguished record of service to the profession. He was admitted to membership in the Institute of Chartered Accountants of Ontario in 1911, was elected a Fellow of the Institute in 1929, and became its president in 1944-45. From 1942 to 1945 he served on the Dominion Association's Legislation Committee and Board of Examiners-in-Chief, and in 1946-47 was appointed chairman of the Board and of the Committee on Education and Examinations. The orientation test, designed to assist members of the profession in selecting suitable students-in-accounts, was recommended as a result of the work of the Sub-Committee on Personnel Selection of which Mr. Howson was a member. As president of the Dominion Association, Mr. Howson represented the profession at the first Pan-American Conference of Public Accountants held in Puerto Rico in 1949.

Committee Meetings

The Taxation Committee of the Canadian Institute, under the chairmanship of Harold E. Crate, met in Montreal on January 29 and 30 with the Taxation Section of the Canadian Bar Association to prepare the joint brief on amendments to the Income Tax Act which the combined bodies will submit to the Ministers of Finance and National Revenue at a later date.

On February 6, the C.I.C.A. Annual Conference Committee will meet in Montreal to discuss arrangements for the technical program of the 57th annual conference which will take place in Vancouver from September 13 to 16. Chairman of the committee is J. R. M. Wilson, Toronto, and the co-chairman is Robertson D. Noble of Vancouver.

Bequest to Institute

A legacy in excess of $10,000 has been left to the Canadian Institute of Chartered Accountants from the estate of the late John F. Helliwell, one of the founders of the Institute. The income from this bequest will be used for prizes in the uniform examinations in a manner yet to be determined. Mr. Helliwell was the father of John L. Helliwell, the present president of the Canadian Institute.

Committee Appointment

W. F. Martin of Vancouver has been appointed chairman of the new Sub-Committee on Long-Range Educational Planning of the Provincial Institutes' Committee on Education and Examinations.

Eighth International Congress

Arthur B. Foye, a past president of the American Institute of Certified Public Accountants, has been appointed chairman of the Eighth International Congress of Accountants to be

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held in New York City from September 23 to 27, 1962.

Taxpayer in the Courts

The taxpayer won 38% of the taxation cases heard in Canadian courts in 1958, reports CCH Canadian Limited, national reporting authority on tax and business law. In appeals before the Income Tax Appeal Board, the Exchequer Court, and the Supreme Court of Canada, the taxpayer came out on top in 103 out of 271 decisions. The Minister won 168.

Latest Publication

"Small Retail Store Accounting", a selection of articles that appeared in *The Canadian Chartered Accountant* during the past six months, has just been published as a brochure by the Canadian Institute. These articles deal with some of the problems of financial management and merchandising and provide useful "how-to-do-it" information for the retail merchant. Among the topics covered are merchandising planning and merchandising control, cash control, sales and credit problems, planning the budget, and problems of income tax. The brochure is available from the Institute at $1.25 a copy.

Members of the Institute will be familiar with the material in the booklet, but a great deal of satisfaction might be gained if they were to purchase copies for those of their clients in the retail field who are not so well informed. The brochure deserves a place on the shelf of any small retail storekeeper who is concerned with sound accounting practices and intent on seeing his business prosper.

Publication Sales

More than 2,000 copies of "Canada's Investment Business", a collection of articles published in *The Canadian Chartered Accountant* during 1958, have been sold since the brochure was published last September.

Among other Institute publications, "Financial Reporting in Canada" and "Integrated and Electronic Data Processing" have each sold more than 1200 and 1100 copies, respectively, since their publication in the fall of 1957, and sales of "Municipal Finance in Canada" have almost reached the 1000 mark. "Accounting Terminology" is now in its second printing with sales exceeding 6000 copies. A complete list of C.I.C.A. publications and a convenient order form appear on pages 166 and 167 of this issue.

In the News

William Rathie, C.A. (B.C.), has been elected an alderman of the City of Vancouver.

Editorial

SATISFACTION OF A PUBLIC ACCOUNTING CAREER

It is said that for most people the greatest single source of satisfaction lies in the sense of achievement. Consider the pleasure of the child when first it walks, the thrill of the adolescent who "makes" the school football or hockey team, the reactions of the college senior who graduates with honours, the student of accountancy when he becomes a chartered accountant. All of these are legendary delights of great moments, but they all stem from the same source: the sense of achievement. Perhaps achievement contributes so much to our well-being because it is distinctly personal and carries with it a gratifying sense of permanency. Wealth, health, the pursuit of happiness, and many other causes of satisfaction may be temporary. The sense of achievement is a lasting one. Once gained it is never entirely lost.

Where does one find achievement? It is realized in any situation where an objective is attained by one's own endeavours, and most particularly where the objective is of benefit to others. Thus, for a career in achievement, one instinctively turns to the professions: the church, medicine, law and, more recently, to science and public accounting. All professions are in essence services performed for the benefit of others; the word "profession" itself is defined in the Oxford dictionary as "a vocation in which a professed knowledge of some department of learning is used in its application to the affairs of others".

The professions inevitably move with the times and undoubtedly reflect all great social and economic forces. Accounting, as a profession, is the outgrowth of the enormous scientific progress and industrial developments of the past century. As the activities of business and government expand, so does accounting, always keeping pace with evolution and sometimes providing leadership to help integrate harmoniously the results of scientific advancement with the economics of business. Currently, accounting is becoming the

barometer of progress. Everyone is affected, although the wide impact of accounting and accounting principles is not always recognized. Accounting and the application of accounting principles and procedures play an important part in every aspect of our daily living. They affect the cost of all consumer goods and services, including light, fuel, communications, transportation, food, clothing, and household goods, and appliances of all kinds. They play a prominent part in the cost determination of all minerals, of all products of the forest and the sea, of all buildings, structures, industrial equipment, and other products of heavy industry. They concern the income of individuals, particularly self-employed persons, those with investment income, and those confronted with income tax and succession duty problems.

Good accounting provides the means of measuring business activity and productivity. It furnishes the indices and statistics on which business management must base its judgment of what to do and what not to do. It establishes the cost of goods produced and the selling price of goods sold. It computes the profit or loss on operations, the amount of income subject to tax, and the amount of income and other taxes payable. It produces good financial reporting, and good financial reporting supplies the information and creates the confidence necessary to attract new capital and thus creates more productivity and more business activity. Without good financial reporting, based on sound accounting principles, our entire industrial economy might collapse.

Professional public accountants, individually and collectively, have played a major part in the determination and application of sound accounting principles which have become generally accepted. In addition, they have collaborated actively with business in its continuing efforts to improve the quality of financial reporting and, in their capacity as auditors, they have done much to ensure the reliability of such reporting. The profession has always been deeply conscious of its obligation to the public as well as to its clients. Through established custom or, where necessary, by legislation, it has been a leader in advocating the adoption of steps necessary to bring about good financial reporting which so vitally affects the economy and which concerns the livelihood of everyone. This is a fast-growing and far-reaching profession which must necessarily keep pace with new developments, new procedures, and new thinking. The scope is limitless, and continues to offer a path to achievement, which may be rough in places, but which will provide sufficient stimulating experiences to bring lasting satisfaction to all those willing to accept the challenge.

VALUATION OF GOODWILL

ARTHUR J. LITTLE

RELATIVELY LITTLE has been published in Canadian magazines and periodicals on the subject of goodwill, but research reveals a surprising amount of material in publications of other countries. A few Canadian court tax cases deal with goodwill but these do not add much to earlier writing and, in fact, often quote earlier definitions and methods of valuation. Perhaps this is not surprising because the term "goodwill" has been used in commercial parlance for a great many years and with fairly consistent meaning.

It is intended in this article to deal generally with goodwill of a commercial or financial business, although "professional goodwill", a large subject in itself, will be referred to briefly.

What is Goodwill?

This article is concerned with the meaning of goodwill in a commercial or business sense. The word is used in a number of other ways, as in "men of goodwill" or "a goodwill token", and means, for example, "a kindly feeling towards a person" (Concise Oxford Dictionary). The Oxford dictionary gives a commercial meaning to the word in the form "privilege granted by a seller of business, of trading as recognized successor". This seems to come close but is not quite the commonly accepted business meaning of the term, for there may be no goodwill, as we think of it, in the mere privilege of trading as a recognized successor. If trade does follow the successor, then goodwill presumably exists. Back in 1918, in the earliest reported legal decision on the subject (*Crutwell* v. *Lye*) Lord Eldon said: "The goodwill which has been the subject of sale is nothing more than the probability that the old customers will resort to the old places."

This oft-quoted definition seems to come closer to the mark than does the Oxford dictionary and compared with other definitions has the advantage of great simplicity.

In 1952 the Research Committee of the Society of Incorporated Accountants (England) published a pamphlet entitled "The Valuation of Goodwill", which incidentally is very interesting and most useful to anyone who faces the problem. That pamphlet contains the following definition, which is virtually the same thing propounded by Lord Eldon: "Goodwill consists of those elements in business relationships which make a continuance of

such relationships probable, notwithstanding a change in the ownership of the business."

Numerous authorities and many legal decisions give similar definitions, some of which are quite lengthy and complicated. All say about the same thing, and the two quoted above seem to cover the essential qualities and are simple and understandable. It will be noted that neither of these definitions refers to the value of goodwill or the likelihood of the goodwill producing earnings not otherwise obtainable. In our view, the goodwill element can exist without having a monetary or saleable value. The fact that custom returns to the old stand does not in itself result in additional profits and, in fact, may not produce profit at all. However, many competent authorities in defining goodwill link it closely with income-producing capacity. For example, H. E. Seed in his work "Goodwill as a Business Asset" says:

> "Goodwill is the advantage which arises from the good name, reputation and connection of a business; alternatively, the benefit which accrues to the owner of a business from the likelihood that such business will earn, in the future, profits in excess of those required to provide an economic rate of remuneration for the capital and labour employed therein."

There are many authorities which define goodwill in much the same way as Seed, and many make use of the term "super profits" to describe the additional earnings produced by the goodwill factor. "Accounting Terminology", published by the Canadian Institute of Chartered Accountants, refers to both the nature and value of goodwill in the following terms:

> *Goodwill.* The intangible assets of any established business which has value in excess of the sum of all other net assets. Goodwill has had a variety of definitions, some relating to the nature of the asset, others to its value. As to its nature, it has been said to fall into the three classes of commercial, industrial, and financial goodwill, which are the consequences of favourable attitudes on the part of customers, employees, and creditors, respectively. As to its value, the most common explanations emphasize the present value of expected future earnings in excess of the return required to induce investment. In practice, when a going concern changes hands, the goodwill is frequently valued by some rule of thumb such as so many years purchase of average annual earnings.

In Canadian practice it is probable that the term is used most frequently to describe the extra earning power that can be produced by a business over and above a reasonable return on the investment in tangible assets. Notwithstanding this common usage, it seems reasonable to think also of the elements which make up goodwill, as well as what saleable value it may have. It is easy to think of examples where the goodwill elements are present, but where there may be no earning power. A company may have substantial sales volume, good reputation and product acceptance by the market, and yet for some reason be unable to make a profit. Surely good will is present, but in the circumstances is not apt to be valued highly by a prospective purchaser.

Going-Concern Value

A company already set up and in motion may have some intangible value, even though it may not have demonstrated any earning power. There may be buyers for such a company who wish to avoid the cost and time involved in setting up an organization, obtaining and equipping space, engaging staff and so on. The buyer may not care whether or not old customers will return to the old stand; what he wants is a stand all set up and ready to go. Frequently, purchasers pay a price for this advantage, which might be described as a "going concern value", but which, in our view, is not goodwill although it is often so described.

Inseparable from the Business

Goodwill should not be confused with the value attached to such things as copyrights, trademarks, patents, formulae, etc. These assets may have great value in themselves and are capable of being separated from the business and sold to others. This is ordinarily not true of goodwill. Goodwill refers to intangible elements of the business; and its reputation with its customers, with the public as a whole, with its shareholders and employees. These elements cannot be divorced from the business itself. Goodwill follows the business and may be sold with the business, but cannot be sold separately.

Valuation of Goodwill

There are some very useful articles dealing with goodwill valuation that will be of interest to anyone concerned with this problem. Reference has already been made to "The Valuation of Goodwill", a pamphlet published in England by the Society of Incorporated Accountants. An excellent article entitled "Goodwill and Its Valuation" written by B. J. Sanderson appeared in the July 1950 issue of *The Chartered Accountant in Australia*. A. V. Adamson's book "The Valuation of Company Shares and Businesses" is most useful and contains several chapters dealing with goodwill valuation. These are well worth study, and all refer to the various bases of valuation described by writers generally.

In England and some European countries, the greatest emphasis seems to be placed on valuing goodwill by one or other of the "super profits" methods, and most popular seem to be those which adopt an annuity method of valuing the "super profits" for a number of future years. Some of the formulae for making these calculations appear complicated. For example, an article in *The Accountant* (England) of March 1, 1958, quotes the formula adopted by the Societe Fiduciarie de France, where –

G – equals goodwill
B – annual profit
c – rate of interest
cV – interest on value of net assets.
n – the term over which goodwill is written off

then, $$G = \frac{B - cV}{c}\left(1 - \frac{1}{(1+c)^{n}}\right),$$

This particular article (by Kenneth S. Most, LL.B., A.C.A.) acknowledges that at best the valuation of goodwill is an approximation, but seems to favour the more precise formulae methods. It goes on to say

> "... One discouraging feature is that, although accountancy writers and leading practitioners have long advocated the method of valuing goodwill known as 'the capitalization of super-profits' (a description for which we are indebted to the

late P. D. Leake), the cruder methods, previously mentioned, hold sway in the business and legal communities. The criticism levelled at the super-profits method is that it suggests a spurious accuracy where none can ever be attained, and uses a mathematical formula where a rule of thumb would be of equal utility. This criticism cannot be entertained; any method of valuation can be expressed in terms of an algebraic formula, and the most satisfactory formula is the one which follows the best logical argument . . ."

On the other hand, Sanderson, in describing the annuity methods in his 1950 article in *The Chartered Accountant in Australia,* says:

> "It seems extraordinary that what are at best estimates should be subjected to involved mathematical calculations and the answers described — not as a lemon — but as the value of goodwill".

There is no doubt that in Canada it is most usual to adopt one of the so-called "cruder" methods, and to value the total enterprise on an earnings basis and then deduct the real value of tangible assets.

The pamphlet of the Incorporated Accountants on this subject lists six methods for the valuation of goodwill as follows:

1. Number of years purchase of future "super profits".
2. Sliding scale valuation of super profits.
3. Annuity valuation of super profits.
4. Capitalization of future maintainable profits.
5. Mean between tangible assets value and capitalized value of yield.
6. Number of years purchase of past net profits.

These six methods quite naturally produce different results. The pamphlet gives an illustrative example for a medium-size company and the six different results vary from a low of £10,000 to a high of £34,000. This is a very wide swing and obviously if one or two of the results are reasonable, the others must be considered unreasonable.

About method number 4, the capitalization of future profits, the pamphlet says: "This method is different from those already noted, and it cannot be said to be widely used." Oddly enough, however, this is exactly the method which seems to be most widely used in Canada. The description given of the method in the pamphlet also corresponds closely to the following which is submitted as a summary of the procedures ordinarily adopted here:

Step 1. Examine the earnings record. This should cover a suitable period to get a proper representation. Five years is considered a reasonable period, but a longer period is often appropriate. The trend of earnings is important.

Step 2. Adjust past earnings to arrive at future maintainable profits. This is for the purpose of eliminating extraordinary or non-recurring items, adjusting for changes or additions to the business affecting part of the period only, proposed changes in proprietor's remuneration or expense allowances, etc.

These adjustments should not encompass improvement in earnings that may be expected to follow from new lines added by the new owner, or economies that may flow from merging with another business. The previ-

ous owner is not entitled to compensation for the profits flowing from changes of this nature.

Step 3. Determine the appropriate rate of return that should be realized on an investment in the particular type of business being purchased. This requires a study of published information available for comparable businesses. This determination must give full weight to special factors, unusual risks, the size of the business, etc.

Step 4. Total value is obtained by capitalizing the earnings as adjusted in step 2 by the rate of interest arrived at in step 3.

Step 5. Tangible assets and intangible assets other than goodwill (i.e. patents, trademarks, etc.) must be valued. This should be on a going-concern basis, and not a break-up value. Note that any assets which are not required in the business, or which do not produce income should be valued separately.

Step 6. Goodwill value is the difference between the value of assets used in the business (step 5) and the capitalized earning value (step 4). If there are extra assets not required, as noted in step 5, these can be left out of the purchase, or added, at realistic values, to the purchase price.

While the foregoing is submitted as a summary of the usual Canadian method of valuing goodwill, it is really an outline of the basis of valuing a business, from which the value to be attached to goodwill can be deduced. The problem of valuing a business is a complex one, and not nearly so simple as the above outline might suggest. There is much helpful material available on the subject of valuing a business and it cannot really be separated from the problem of valuing goodwill. It is, however, very much a matter of opinion, but one based on all available information. The problem of valuation was well summed up by Mr. Justice Douglas of the United States Supreme Court (as quoted in a recent brochure on the subject published by Messrs. Ford, Bacon & Davis) when he said:

> "Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earning record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance".

Book Value not a Factor

Very often goodwill is taken to be the difference between the total amount a purchaser agrees to pay for a business and the book value of the tangible assets to be acquired. This is a mistake, but one commonly made. Historic asset values probably bear little relationship to current values in most cases, and a vendor would not ordinarily dream of selling at such values. It is essential to arrive at a realistic value of the tangibles, by formal appraisal if necessary, before the amount attributable to goodwill, if any, can be determined.

It is clear also that two businesses with similar earning capacity may have quite different dollar values placed upon their respective goodwill assets simply because the value of the tangible assets employed may be quite

different. And this is true even though the actual goodwill characteristics or elements are very similar.

Goodwill of a Professional Practice

Most practising accountants will have occasion to consider the valuation of their own particular practice, or that of some client or colleague in some other profession (legal, engineering, etc.) or in a strictly personal service type of enterprise. The basic elements of goodwill for such businesses are somewhat similar to those in a commercial enterprise, but the methods of valuation are quite different. It must be remembered that professional goodwill is closely bound up to the individual and is ordinarily inseparable from him. Consider for example a concert pianist who develops a great reputation and great earning power. One can scarcely say that there is no goodwill attached to this professional income earning career, and yet it certainly can never be sold or transferred to someone else.

On the other hand, professional accountants practising in partnership can generate goodwill within an organization which can certainly be sold for money to other practitioners, and particularly if the vendors agree to refrain from competition. However, a special approach must be made to valuing professional goodwill, and it cannot be adequately dealt with in an article of this length.

Conclusion

If the foregoing general observations about goodwill and its valuation are reasonable, the following conclusions can be drawn:

1. Goodwill of a business is intangible, and refers to elements and characteristics of the going concern such as its general reputation with its customers, the public, labour, and shareholders, and the acceptability of its products and the likelihood that customers will continue to buy them. It can exist, however, without having any significant monetary value.
2. Goodwill should not be confused with "going-concern" value, or the price that a buyer is willing to pay for a commercial enterprise already in motion (over and above real value of tangible assets) simply to acquire a ready made organization, even though it may not have demonstrated any normal earning power and the buyer may not care about retaining former customers.
3. Goodwill (except in most unusual circumstances) cannot be divorced from the business enterprise itself; therefore, it is saleable only in conjunction with that enterprise.
4. The commercial or saleable value of goodwill, therefore, depends upon the earning power of a business and its total value as a continuing enterprise.
5. The saleable value of goodwill is the difference between the total value of the business as a going concern and the value of all other assets employed in the business. Goodwill is not, though it is often taken to be, the difference between total sale price of a business and the *book value* of the assets sold.
6. The valuation of goodwill is a matter of opinion and is, at best, an estimate.

The Role of Factoring in Business

SIDNEY H. LEVY

FACTORING is more than financing. It is a business service that eliminates bad debts and relieves management of the responsibility for credits, collections and accounts receivable bookkeeping.

Today the chartered accountant is called upon to guide and advise his clients in a multitude of problems. Consequently he should know something about this method of dealing with accounts receivable; he may suddenly find to his surprise and to his client's satisfaction that factoring is a very simple way to solve a variety of problems, usually without any extra expenditure.

Factoring services are widely used in many industries, particularly textiles, and are just about as widely misunderstood. Frequently factoring is deliberately avoided because it is mistakenly believed to be too costly or an indication of financial weakness. This misconception of its role in business exists notwithstanding that in 1957 in the United States alone factored sales exceeded $4½ billion.

Factoring can best be defined as the outright purchase of a company's accounts receivable without recourse against the seller for credit losses or slow payments. The factor takes the full risk. The client company may convert all its sales into cash before maturity, in fact just as soon as the goods are shipped. This can often accelerate a company's growth and is useful where the "bank credit line" is insufficient to allow an aggressive well-managed firm to avail itself of its full sales potential. Factoring provides the funds which put sales opportunities within grasp and thus increases profits.

History of Factoring

The factor had his origin in the United States more than a century ago. In the early days, he was what we now call a "commission merchant". He actually sold merchandise and assisted in merchandising and styling. Gradually, the manufacturer found he could get good advice from the factor on the granting of credit to customers and was soon ready to turn this responsibility over to him. Sooner or later bad debts were incurred, and the manufacturer was then glad to pay the factor an extra fee for absorbing losses resulting from credit extended on the latter's recommendation. The next short step was for the merchant to request and receive a cash advance against a credit guaranteed shipment. These advances

were secured by a transfer of the outstanding accounts receivable.

This process was particularly attractive to manufacturers who were far distant from their customers, and its development in the export trade was very rapid. As the factoring industry grew, factors discovered that selling and merchandising on the one hand, and credit checking and collecting on the other, were two distinct operations which were in effect incompatible and best handled separately. Gradually they began to give up selling and merchandising and to devote their whole energies to perfecting the functions of checking credits and financing sales without recourse. By the early years of the twentieth century, the evolution was complete.

The term "old line factor" is used frequently to describe factoring companies offering these comprehensive services in contra-distinction to those engaged merely in recourse sales financing, that is financing receivables without accepting the credit risk.

A Benefit to the Medium-Sized

Factoring offers the greatest advantages to industries made up of a large number of medium-sized manufacturers. Very often these companies need customer credit protection which the factor can give by guaranteeing full payment of their accounts receivable. Frequently they can make profitable use of the additional working capital to develop more rapidly.

Specifically, companies in one or more of the following categories will benefit from the factor's services:

1. Companies desiring to protect that portion of their capital represented by accounts receivable.
2. Companies losing sales or suffering excessive credit losses because of inadequate credit and collection facilities.
3. Companies whose sales expansion is limited by lack of cash rather than by lack of customers.

Today in the United States and Canada, the textile and allied industries lead in the use of factoring services. Factoring is also used by manufacturers and wholesalers of floor coverings, paints and varnishes, glass, soap, china, cutlery, leather, toys, drugs, household furniture and appliances, and lumber and lumber products.

Factoring offers a "package" which will check credits, guarantee credit risks, handle receivables, bookkeeping and collections, and advance cash against shipments.

Credit Checking

Many companies, especially of medium or small stature, are unable to maintain adequate credit departments simply because the fixed overhead costs of staffing and supervising them are too high in relation to sales. However, since the factor is really the composite credit and collection department of all his clients, he can spend more money on credit information, collection procedures and trained personnel. Through factoring, the client company immediately acquires these specialized services and can regard them an an integral part of its own organization. It will not, however, be burdened with the heavy costs of maintaining them.

The factor's life blood is the purchase of accounts receivable, and he is attuned to accepting credit risks as an occupational hazard. He will not profit long by taking only "gilt-edged"

accounts because his own growth depends upon the growth of his clients. Moreover, he is a specialist in credits and is spreading his risks over a far greater sales volume and among diversified industries. Thus, through factoring, the client can accept additional business from customers about whom it formerly could not obtain adequate up-to-date information on which to base a proper credit line. It can also increase its sales to customers whom it formerly rejected because of the risky size rather than the risky nature of the orders.

100% Credit Guarantee

Once the client ships with the factor's credit approval, the factor guarantees the whole credit risk. Furthermore, he pays the client in full on the due date, according to the client's own selling terms, even if the customer cannot pay. (A few days are added to the terms of sale to take care of normal slow payments, mailing and collection time.)

Collection Service

Once the client has sold its receivables to the factor, the latter, as owner of the accounts, attends to all the bookkeeping and collection details. He posts ledgers, draws drafts, sends statements, follows up collections and absorbs all the expenses associated with these procedures. The client's work and worries are ended.

Merchandise Disputes

While the factor's credit guarantee covers the accounts receivable, it does not cover disputes between client and customer as regards merchandise or repudiation of merchandise contracts by customers. A factor, when purchasing an account receivable, assumes he has acquired a valid obligation on the part of the client's customer to pay for merchandise without dispute. If such an obligation does not exist, the factor has not received a valid debt and is entitled to rescind the transaction.

However, if the customer fails to pay because of financial inability, the factor has no cause for complaint. The financial inability to pay does not destroy the validity of the obligation but merely affects its value. The factor must bear the consequences.

Maturity Payment Guarantee

The services so far discussed may be called "maturity payment guarantee" because the factor guarantees payment in full at the maturity date of the invoice. While it is true that many clients make use only of this portion of the factor's services, there are important additional facilities available, and these deal with "accounts receivable discounting".

Cash for Shipments

The keynote of "accounts receivable discounting" is cash upon shipment. An important feature of factoring is that advances are available against accounts receivable immediately upon shipment of merchandise. While some clients have no need for this service, others owe their growth to the additional working capital thus provided.

Discounting sales through the factor is not borrowing. Since the factor has actually purchased and guaranteed the account in the first place and there is no recourse against the client in the event of non-payment by the client's customers, the factor's advances are self-liquidating. He looks to the customer, not to the client, for repayment. Consequently the advances are not loans, and they con-

EFFECT OF FACTORING ON A BALANCE SHEET

BEFORE FACTORING

Accounts receivable	$150,000	Bank loan	$ 75,000
Inventory	210,000	Accounts payable	165,000
Current assets	$360,000	Current liabilities	$240,000

Ratio of current assets to current liabilities 3 : 2

AFTER FACTORING

Balance on deposit with factors	$ 30,000	Accounts payable	$120,000
Inventory	210,000		
Current assets	$240,000	Current liabilities	$120,000

Ratio of current assets to current liabilities 2 : 1

stitute a continuing addition to the client's working capital.

In other methods of financing, a maximum limit is usually set beyond which accounts receivable will not be discounted because the recourse against the borrower is related not so much to the receivables themselves as to the borrower's capital. The distinguishing feature of factoring is that the factor does not limit the total advances to the client. The client can make full use of its accounts receivable even at seasonal peaks and convert them into cash as required. This process eliminates the danger of a company encumbering itself with excessive accounts receivable and choking on its own expansion. It is a most important feature of factoring because one of the greatest sources of commercial credit available to the manufacturer or distributor is its own accounts receivable.

The "accounts receivable discounting" arrangement is actually a revolving credit, limited only by the client's ability to manufacture, sell and ship, thereby generating accounts receivable.

A simple example (see above) may show the effect of this phase of factoring on a balance sheet.

At the inception of this factoring arrangement, the client sells its accounts receivable to the factor and immediately receives 80% of their face value, in this case $120,000. The remaining 20% of the receivables is a reserve for price adjustments, returned goods and merchandise disputes, which becomes payable at maturity of the accounts. With this money the client has paid off its bank loan and has also reduced its liabilities to the creditors by $45,000. The reduction on both sides of the balance sheet has improved the ratio of current assets to current liabilities fom 3 : 2 to 2 : 1.

As receivables mature, the client will be paid the 20% reserve withheld. As new sales are made creating new receivables, the client will get the face value of these receivables in cash, less a reserve. This will enable the client to earn more discounts on its purchases and expand its business.

This client has received $120,000

and will receive more if its business grows and receivables increase, but it has not given up any share of its profits, nor has its management control been affected. In accomplishing all this, it has not even incurred a debt!

Seasonal Problems

Some firms have seasonal problems to the extent that they must accumulate inventory in advance of the shipping season. Others find it profitable to ship their merchandise early and extend to the buyer "extra dating" in the form of longer terms. Factoring solves both these problems by providing "inventory loans" which will be liquidated automatically when the merchandise is shipped and converted into an account receivable, and by converting the long-term account receivable into cash at time of shipment.

Factoring and Banking

While the financing provided through factoring frequently enables the client to dispense with bank loans, it should not be assumed that the client must sever its relations with its bankers. There are numerous occasions when banks continue their financing unaltered and uninterrupted by the factoring agreement.

Sometimes bank loans are made upon the satisfactory credit standing of the client. Sometimes they are for specific purposes, such as raw material inventory financing, and may be secured under section 88 of the Bank Act. Sometimes the loans are secured by the factor's credit guarantee on the client's accounts receivable outstanding. (The moneys payable by the factor to the client can in certain circumstances be assigned to the bank for the latter's protection.) It is not uncommon to find banks and factors working together to supply the client with its legitimate requirements justified by competent management and good profit potential.

Effect on Customers and Suppliers

How does all this affect the customer? Actually it has no effect, although the man who has never used factoring services, or the accountant who is not acquainted with them, may fear all sorts of terrible consequences. Despite its widespread use and growth, an understanding of factoring is still limited largely to those who participate directly in its operation as client, customer or accountant. The degree of misconception is about in inverse ratio to the amount of personal experience and contact. Actually, clients need not worry about a customer's adverse reaction. Experience shows that the customer will always buy if the quality, terms, price and delivery are right. Factoring makes no difference to him.

What about suppliers? Here again, once the function is understood, the client's suppliers should feel secure in the knowledge that its working capital cannot become impaired through bad debts or slow customer's payments. The very act of factoring enhances these assets of the client. When the client augments this by using the factor's accounts receivable discounting plan, it immediately puts itself in a better cash position, can pay his bills more promptly and avail himself of cash discounts. How could suppliers resent this?

Factoring Costs

The factor customarily charges the client in two parts, each related to a different function:

The first part is the "factoring com-

mission" on the net amount of receivables purchased. This fee covers:

1. Investigating and approving the credit risks.
2. Administering and collecting the accounts receivable.
3. Assuming the full credit risk on the accounts purchased.
4. Guaranteeing the client payment of invoices in full at maturity.

The rate of commission will be determined by taking into consideration the following variables:

1. Volume of sales factored.
2. Number and average dollar value of invoices.
3. Degree of credit risk involved.
4. Selling terms to customers.

The factoring rates may range from a low 1½% for clients offering the most favourable combination of these variables, up to possibly 2½% for clients whose sales embrace the least favourable combination.

The second part of the charge is a per annum rate of interest charged when the receivables are discounted. The factor has purchased the receivables as one buys any tangible asset and will pay the client when its invoices mature. However, if the client desires funds prior to this maturity date and the factor in effect prepays or supplies cash before maturity, interest is charged from the date of the advance to the date of maturity. Where a customer cannot pay its account at maturity, the factor does not charge the client any additional interest. The burden of carrying overdue accounts is that of the factor.

While the purchase of each individual receivable is in a sense a separate transaction, it actually forms part of a larger arrangement or relationship between the client and the factor. This involves the purchase of a great many receivables over a period of time and cannot be evaluated from a credit point of view without taking into account the continuing flow of all the receivables purchased. For this reason, the factoring contract generally runs for at least one year and stipulates that all the client's sales are to be factored. This procedure gives the factor a diversification of risks and permits him to pass on to the client the most economical rates.

Drop Shipment Factoring Plan

Sometimes an aggressive salesman can earn more selling in his own name than he can as a commission agent. Too often, however, he cannot obtain the necessary credit from the manufacturer. In such cases the factor will act as stake-holder and pay the manufacturer against his bill of lading. The balance of the sale price less factoring commission goes to the salesman. Thus, the manufacturer and salesman enjoy the profits of a sale which otherwise would not have been consummated.

Accountant's Role

No responsible factor will accept business unless he knows something about the financial condition of his prospective client. For this purpose, great store is put upon the financial statements as reported upon by the prospect's auditor. Unless these statements reflect a satisfactory financial condition, the account will not be accepted by the factor. Once the account is accepted and the factoring arrangement proceeds, the client will submit regular annual financial statements and the auditor's report thereon. In some cases, depending upon the nature of the business, these statements may be submitted semi-annually.

Savings to the client resulting from the elimination of credit and collection departments have been outlined above, but how about savings in direct accounting costs? Factoring eliminates maintenance of ledger accounts for each customer, posting of sales and cash receipts, periodic trial balances and balancing to control accounts. Ordinarily, the client need only prepare adding machine tapes of his invoices daily, weekly or monthly, depending upon volume, and post the totals to debit of the factor and credit of sales. It should not be difficult for the auditor to figure the resultant savings to his client in dollars and cents.

In contra-distinction to the acceptance companies, the services of the "old line factors" are not available to firms who sell predominantly on the instalment or deferred payment plan, or to businesses that are of a long-term nature or composed principally of consumer credit sales.

In assessing the value of the services rendered by a factor, it must be remembered that factoring provides a number of functions and the factor assumes the burden of a variety of expenses. For example, some of the larger factors offer services of an advisory nature such as marketing research and business advice, for which they make no extra charge. These services present intangible advantages which can be extremely useful especially to the medium-sized and small client. The growth of factoring is obviously due to the demand for some combination of the comprehensive services, not simply due to the need for money.

Education: Yesterday and Today

Education was once a simple process. You placed together a pupil, a desk, a cane and a teacher, and lo – there it was, education! The room smelt of ink and chalk, and a great gulf lay between the towering man at the blackboard and the cowering child beneath him.

Times have changed now, of course. There is still some fear and ignorance in our schools, and they still smell of ink and chalk. There is still a gap, too, between pupil and tutor. But the gap has greatly narrowed, and the fear and ignorance has diminished. Many classrooms these days are painted brightly, and smell of flowers; many teachers are more enlightened. Modern psychology is on the march, bent on driving out the last of the old demons.

This change, however, is not without drawbacks – or so many professional men think. They are glad to see the worst features of the old system vanish. But they are afraid that in loosening the old system from its straight-jacket we have dislodged it from the solid basis on which it rested– those three R's, reading, writing and arithmetic.

– *The Chartered Accountant in Australia*, June 20, 1958.

The Corporate Structure in Estate Planning

C. P. GLOVER AND C. W. J. HARPER

A CORPORATION is an entity separate and apart from its stockholders. In the case of a proprietorship and a partnership, death legally puts an end to the business as a going concern. However, a corporation lives on, and this quality makes it an attractive estate planning tool.

There are many characteristics of a corporation which make it a valuable instrument in estate planning. Among the most important of these is the division of ownership and control which is possible. In recent years this has been developed to a very high degree with the result that through the use of multiple classes of stock and through inter-company exchanges of stock many useful business and estate planning purposes may be served.

An Illustration

Possibly the best way to illustrate this is to examine an actual situation where a close corporation is the dominant estate asset. The situation is one in which the estate owner, in his early fifties, is the sole owner of a close corporation engaged very profitably in manufacturing consumer goods. The present value of this business is about $400,000, consisting of one class of stock. The total value of the estate is about $500,000. The estate owner's wife is in her early fifties, and his two sons, both of whom are employed by the business, are in their late twenties.

The problems in this estate are:

1. Lack of liquidity on the death of the estate owner.
2. Ownership and control of the company not only on the death of the estate owner but also during his lifetime.
3. The necessity to curtail the growth of the estate in order that the liquidity problem will not be aggravated further.

The first two problems can be solved by the sons entering into a buy-and-sell agreement with their father, funded by life insurance. On their father's death the sons would be obligated to purchase his shares of stock of the corporation and the life insurance proceeds would provide a substantial down payment. However, this solution leaves the third problem unsolved.

Business Reorganization

A reorganization of the business offers interesting possibilities. The first step is for each son to form a new company. One of the new com-

panies would then take over the sales activities of the present company and the other would engage in the manufacturing end of the business. In the case of the sales company there would be few assets which it must acquire, with the possible exception of inventory. In the case of the manufacturing company, consideration should be given to having it lease the necessary equipment from the present company rather than purchasing it outright. This would enable the estate owner to control, effectively, the manufacturing company, not through the ownership of shares, but through the ownership of equipment and real estate.

The estate owner would then sell to each of the new companies one share of the present company. The purpose of this would be to bring the present company under the definition of a controlled corporation for the purposes of section 28 of the Income Tax Act.

The two new companies would then obtain insurance on the life of the estate owner. An agreement should be entered into requiring these companies to purchase equally the shares of the present company from the owner's estate upon his death. Each son, after the death of the father, through his company would share in the ownership of the present company which would then be engaged in the equipment and real estate rental business. As the estate owner would not control either of the new companies, insurance owned by them on his life would not be subject to tax under the new Estate Tax Act.

This reorganization would channel increases in value resulting from business growth to the sons. This could be accomplished by creating only one new company either operating or holding, but such a plan would have less flexibility than the one proposed.

Possibly management talents of one of the sons may not develop to the satisfaction of the estate owner, or the son may wish to seek his fortune elsewhere. It would be an easy matter for the estate owner to divert the business which had been channelled through that particular son's company back into the present organization.

No effort has been made to keep the two new companies from becoming associated with each other for income tax purposes. To do so would call for a sacrifice in flexibility which is undesirable from the estate owner's point of view.

The reason for ensuring that the present company be classified as a controlled corporation now from the standpoint of the two new companies is to establish the designated surplus so that all profits earned subsequently can be paid later to the new companies as dividends free of corporation tax. The advantage in this is that after the new companies purchase the shares of the present company funds may be drawn off if available and if required to pay off the estate.

Stock: A Tool

Let us now examine some of the tools available to provide a desired division of ownership and control of a corporation. Probably of first importance are the various stock interests which are available.

Non-voting common stock can be issued under a Dominion charter. It is prohibited specifically by the Ontario Companies Act. However, under the Ontario Act it is possible to have an issue of preferred stock

which has a preference as to dividends only. Such stock can share equally in the equity along with the voting common stock and for income tax purposes is classed as a non-voting common stock. This opens a wide avenue in the planning field to permit the spread of company growth among members of a family, at the same time keeping control where it will be most beneficial for the family as a whole. In organizing a new company this class of stock should not be overlooked.

Voting common stock historically has been the stock which has controlled corporations. It is still important and basic, but it has been joined by other voting issues which are playing an important part in many situations today.

Until recent years voting privileges in preferred stock usually were restricted. However, with the development of family planning in this country many corporations have been organized with control vesting in voting preferred stock. This is a very simple way of achieving flexibility in family planning.

Let us suppose that an estate owner wishes to engage in a business and he chooses the corporate form of organization. He may not wish to participate in the growth of this business or he may want to participate to a limited extent only. To the extent that he wishes to participate in growth he will subscribe for common stock. By creating a share structure including sufficient redeemable voting preferred stock to control the company and holding this stock himself, he can control the company without owning any common stock. If the time arrives when he wishes to withdraw from ownership, by arranging to have his preferred stock redeemed, his capital is released and voting control passes automatically to the owners of the common stock.

The example in the foregoing paragraph illustrates, in a simple way, how the following basic estate planning objectives may be achieved in an estate situation dominated by a close corporation interest:

1. It provides for freezing, either in whole or in part, the estate owner's interest in his close corporation.
2. With control in the hands of the owner of the redeemable voting preferred stock of the corporation it permits the transfer of equity growth to the next generation.
3. On the death of the estate owner the redemption of the voting preferred stock will provide liquidity in his estate. This may only be accomplished if some funding method, such as the ownership of life insurance on the life of the estate owner, makes money available to the company to effect the redemption. Life insurance funding should be considered only with the provisions of the new Estate Tax Act in mind.

Unfortunately, there is little "preventive estate planning" done in the sense of planning to avoid problems arising. Most planning commences only after problems are recognized as existing. This is especially true of situations where a close corporation interest represents the greatest part of the value of a man's estate.

As a result of the complex nature of the problems which arise around such a close corporation interest, recognized estate planning techniques, in many cases, call for a multiple corporation type of business organiza-

tion. As conditions vary from situation to situation, there is no clear cut formula of general application which will enable professional advisers to resolve these problems on behalf of their clients. There is an ever expanding field for accountants and lawyers who have imagination and who are prepared to do some constructive thinking. Multiple corporation type of business organization can be complex. However, there are a few basic methods of procedure upon which many estate plans are built.

Holding Companies

One of these is the formation of a holding company. This is a simple solution where only one family is involved, and many families of wealth have utilized the vehicle to transfer growth to subsequent generations. Basically the technique is to sell common stock having a good growth potential to a new company the common shares of which are owned by members of the succeeding generation or generations. Here again is where the possibility of utilizing voting preferred stock arises, depending upon the degree to which the owner of the original shares wishes to retain control of the new company. Another question which must be answered at this time is whether the new company is to be a taxable corporation or a personal corporation. The decision in each case can be made only in the light of individual circumstances. In this respect there is one fact which, because it is obvious, does not seem to be universally appreciated. This is the ease with which a company can stay out of the personal corporation class by carrying on an active financial, commercial or industrial business. Almost every type of business has some small phase of the operation which can be spun off to another company to perform if required for this purpose. The performances of such an operation by a company which otherwise would be classified as a personal corporation will serve to disqualify it as such.

Operating Companies

Sometimes the formation of a new operating company furnishes the answer to the problem. Such a company can take over the operations of the present company to varying degrees. The one extreme is some nominal type of business which would be undertaken merely to exclude the company as a personal corporation if this was appropriate. The other extreme is the taking over of the total operation, with the original company becoming merely a holding company for securities of the new company and/or fixed assets not sold to the new company but leased to it. The middle road of having each company perform some particular phase of an operation can be particularly useful where there is a son in the business who has promise but has not yet proven himself. For example, the incorporation of a sales outlet for a manufacturing company can enable a division of profit between the two companies to whatever degree is desired. With the son owning the major portion of the common shares, profits accumulated in the sales outlet will accrue to him with a reduction of profits in the manufacturing company which are aggravating the position of the father's estate. The father retains control of the situation as at any time the channelling of business through this second company can be cut off if the son does not develop in the anticipated manner. It may be possible by limiting the interest of each

party to one company only to avoid the classification of "associated" for income tax purposes and gain the benefit of two initial tax brackets.

Other Possibilities

The possibilities of combining a holding company and a new operating company should not be overlooked in these circumstances. For instance, in a father and son situation where the original company is controlled by the father, if a new company controlled by the son is formed and acquires a single voting share of the old company, the "designated surplus" of the old company is established immediately. This is useful where it is desirable to freeze such designated surplus early but the principal shareholder does not wish to relinquish any of the growth of the business for the time being. Under these circumstances, the company probably would be strictly a holding company. On the other hand, the new company would become an active operating company earning profits through some breakdown of the overall operation as discussed earlier. However, with the freezing of designated surplus in the old company early, machinery would be established for draining off funds from the old company at some time in the future if this course of action should prove desirable. This was the situation in the case discussed above.

An alternative to establishing designated surplus early is the avoidance of ever having the old company classified as a controlled corporation and therefore remaining in a position to pay tax free dividends at all times to the new company. Under section 28 of the Income Tax Act the classification as a controlled corporation can be avoided if the second company does not own at least one voting share of the first company. It is possible therefore for a high percentage of the equity value of the original company to be represented by non-voting common shares owned by the new company. This usually requires splitting the authorized common stock of the original company into two classes or, as in the case of an Ontario company, the substituting of no par value preference shares having a preference as to dividends only for a percentage of the common stock. As long as the result is not a change in classification of the stock from common to preferred for purposes of the Income Tax Act, this can be carried out without income tax implications.

From the foregoing, it is apparent that the corporate form of business organization has many important reasons for its existence other than income tax relief and limited liability (which is more theoretical than practical because banks and others who make credit available almost always require personal guarantees of the principal stockholders of a close corporation). In organizing a close corporation, serious consideration should be given to the estate problems of the individual who is responsible for its creation and upon whose shoulders responsibility will rest for its success or failure. Gone are the days when incorporation of a close corporation meant a capital structure of one class of stock. Flexibility should be the key note and care should be taken to protect the family position as far into the future as possible.

One final note of caution is in order. Careful planning may relieve the estate problems of the present generation, but unless care is taken increasing values will create serious problems for future generations.

Control of Warehouse Costs

THOMAS J. DIGGORY

"What is so special about warehouse costs against the more significant product cost elements of material and labour?" The answer to this question depends upon the type of business under consideration. For example, in a manufacturing organization, warehousing costs are overshadowed by other controllable cost elements. In such cases, they tend to lose their identity through being merged with other selling expenses of a semi-fixed nature. This treatment is logical in such a business since the ultimate profit turns on the cost factors encountered in the manufacturing area.

In a wholesaling or distributing business, however, warehousing, packing, and shipping expenses are among the most critical costs of operation, and their control is a vital factor in maximizing net profits. Further, proper treatment of warehouse costs in turn enables expense structures to be understood and periodic management reporting of such costs to be introduced.

Types of Expense

Expenses incurred in warehousing operations, in general, follow the same pattern as those encountered in other types of business. However, in order to give effect to the monetary cost involved in carrying inventory, a frequent practice is to include an interest charge based on the average level of inventory, by product line.

Having determined the nature of expense for the overall warehousing operation, an assessment must be made of the amount of these expenses based on past experience and modified by the level of activity anticipated in the future. The expense anticipated in the forthcoming period will then become the basis for establishing operating budgets. Actual expenses incurred will subsequently be measured against budgets and normal budgetary control techniques applied.

Anticipated expenses or expense budgets must now be allocated to the products handled in such a way as to ensure the most equitable expense distribution, having regard to the nature of the product and the handling involved. As will be seen later, the definition of "products" will depend on the nature of the business. Where the range of products handled is wide, individual products should be grouped into broad significant classifications. Otherwise, allocation of expenses over wide ranges of prod-

ucts requires clerical effort frequently not commensurate with benefits to be gained.

Cost Centres

Expense budgets have to be allocated to cost centres as an intermediate step to give effect to the different treatment required for each product or group of products.

Cost centres can be broadly grouped into the following four major cost areas:—

1. Physical handling
2. Administration
3. Packing
4. Freight.

Physical handling would include receiving, storing, stock picking, and shipping.

Administration would include purchasing, order writing, pricing, billing, and general administration.

Packing and freight are normally considered as two distinct cost centres.

Pre-determined levels for expense budgets are allocated to cost centres according to the significance of each in relation to the centre concerned. For example, payrolls would be allocated directly to cost centres with such proration as may be necessary. Rent would be allocated by area, repairs and replacements by direct analysis. Insurance would be allocated to storing, legal and professional expenses to general administration. A type of worksheet frequently used is shown below.

Allocation of Costs to Products

Careful distinction must be made between products carried in stock for shipment to customers and products sold from suppliers' catalogues. Physical handling and packing are not involved in the latter, as shipments are direct. Administration costs and possibly freight are therefore the only cost elements to be considered in the "direct" shipment from supplier to customer.

Two further factors determine the ultimate share of warehousing cost applicable to any product, whether stock or "direct" shipment: firstly, the type or nature of the product, e.g. hardware, clothing, food, machinery; secondly, the basis of cost allocation to product groups by weight, prime cost, etc.

			COST CENTRES						
			PHYSICAL HANDLING				ADMINISTR		
EXPENSES	DISTRIBUTION KEY	TOTAL	Rec.	Stor.	Pick.	Ship.	Pur.	Order Writ.	Pric
		$							
Payrolls	Analysis								
Unempl. Ins.	% of Payroll								
Rent	Stor. Area								
Insurance	Dir. Storing								
Supp. & Stat.	Gen. Adminis.								
Repairs	Analysis								
etc.	etc.								

COST CENTRES AND METHOD OF ALLOCATION

Purchasing ....On the basis of number of purchase orders handled.
Pricing ....On the basis of number of shipping orders handled.
General Admin. ....On the basis of sales.
Storing ....On the basis of area cost.
Shipping ....On the basis of weight shipped from past experience.
Packing ....On the basis of types of packing related to sales values.

Before allocating costs by cost centre to products, therefore, it is important that products be grouped by type in order that adequate "weighting" be applied by reference to such factors as volume of sales of each type, weight and/or bulk of each type, amount of packing required, degree of handling necessary, and whether received and/or shipped carload or part-shipment.

Allocation of cost centres to product groups can then be made. Examples of methods of allocation, as shown above, will explain this point.

The illustration shown below outlines this allocation in the form of a worksheet.

After the cost by product group is determined, this cost can then be related to sales cost or weight by product group and a percentage mark-up calculated. This mark-up would also include prepaid freight as a variable factor dependent upon ultimate destination.

Cost Control

The control of warehouse costs expressed as a mark-up on products can be handled on a continuing or a periodic basis. If a continuing basis is

COST CENTRE	DISTRIBUTION KEY	TOTAL	TYPE OF SHIPMENT					
			DIRECT			STOCK		
			Type of Product					
		$						
Physical Handling:								
Receiving	Test					(Applicable to stock shipments only)		
Storing	Floor Area							
Picking	Payroll Analysis							
Shipping	Test & Sales Analysis							
TOTAL								
Admin. & Clerical:								
Gen. Admin.	No. of Transactions							
Purchasing	No. of Purchase Orders		(Distributed over all types of shipments)					
Billing	No. of Invoices							
etc.	etc.							
TOTAL								
Admin. & Clerical	% of Sales		%	%	%	%	%	%

used, this will involve spreading back all expenses by cost centre and product on a monthly basis. This involves much detail work, including a possible restudy of bases of allocation. For this reason it is carried out infrequently.

A periodic basis for control of the product mark-up involves less detail work and yet in practice usually proves quite adequate.

This procedure has three basic steps:

1. *Control of expense*

Comparison of each type of expense on a monthly basis against a predetermined proportion of the target budget used in determining the original mark-up. Investigation of variances will determine the validity of present mark-ups and indicate areas where costs may be increasing rapidly and necessitate a further study.

2. *Control of bases of allocation*

Periodic studies can be made during the year to determine whether the original bases of expense allocation are realistic. Statistical sampling techniques can be used where appropriate.

3. *Control of mark-up*

Annually or more frequently, depending on the results of 1. or 2. above, a detailed analysis would be made and necessary revisions incorporated into the pricing structure.

The principles of warehouse cost control are designed to ensure that each product bears an equitable proportion of warehousing cost. As in the majority of costing problems, certain arbitrary decisions must be made in determining bases of allocation. However, where a wide range of products is handled, it is vital that the incidence of cost by product group be known to management. Significant changes in the pattern of sales could well affect the handling cost disproportionately. Studies of this nature made for the first time frequently reveal cost patterns not previously recognized.

Having determined the most equitable allocation of cost to products, it is important that actual expenses be controlled through comparison against the budget on a continuing basis. Variances from budget must be investigated to determine their cause and ultimate effect on the warehousing mark-up by product.

The aim of this method of expense allocation to products is to obtain a broad indication of the incidence of cost, to aid management to control costs and to establish selling prices based on accurate information.

Old accountants never die, they just lose their balance.

—Anon

Profit Sharing: Key to Industrial Peace

DOUGLAS D. W. IRWIN

REPORTS MADE by leading Canadian businessmen upon their recent observations of the Russian economy indicate that our Soviet neighbour may soon be capable of industrial output of a volume and standard sufficient to constitute a positive threat in world markets and in the struggle for the allegiance of the neutral and underdeveloped countries of the world.

This discovery has confirmed the apprehension which was engendered by the launching of the first sputnik. Since that time our daily press and periodicals have exhibited equal fascination with Russian technological advances and with analysis of measures designed to maintain and surpass our own industrial genius. In the latter regard the search is in earnest.

The possibility of seeing a spate of Russian products untrammeled by considerations of cost displacing our products in the uncommitted markets of the world must force us to a consideration of means to decrease unit costs, increase productivity, reduce the losses attributable to industrial strife and solve the deficiencies of the distribution of purchasing power which have been the recurrent afflictions of the business cycle.

In this general search widespread application of the principles of profit sharing may provide a new stimulus and direction.

Space does not permit a review of the basic principles of profit sharing or the display of illustrations supporting its achievements. It may be appropriate, however, to review the contribution it can make in achieving industrial harmony.

Social and Personal Responsibility

The greatest single appeal of profit-sharing philosophy lies in its foundation upon the highest Christian ethics and standards of social responsibility. It is not just an economic program but an approach to life. It aims at a rejuvenation of the spirit by orienting the purposes of production to the needs of humanity. The profit motive is thus converted into a dynamic social force.

Idealistic as these principles may seem, they are solemnly subscribed to by a growing body of realistic economists and businessmen. It has been found, in fact, that when management and labour each become concerned with the advancement of the legitimate aims and economic welfare of the other, the concern has been reciprocated to the advantage of both.

Profit sharing has also demonstrated that by giving the employee a new self-interest and a new sense of personal responsibility it has reduced the adverse effects of repetitious functions and standardization so necessary to productive efficiency. While thus providing a new dignity and status to the individual, this has been achieved through the development of team effort in the labour force upon which the final results depend.

Not the least of its advantages is the economic one of increased remuneration to the employee and greater return upon investment arising from lower unit costs and increased productivity. When both labour and capital may expect to receive a fair distribution of profits, both become equally concerned with the cooperative effort which makes profits possible.

Finally the achievement of a high level of consumer income assures the means of distributing output and maintaining full capacity and employment.

While these benefits are attested to by approximately 25,000 firms in the United States covering up to 2 million employees and about 250 firms in Canada covering an estimated 100,000 employees, the concept of profit sharing has yet to enjoy universal acceptance. An extensive educational program is required.

Attitude of Labour

On behalf of management, the Council of Profit-Sharing Industries and its associated Profit-Sharing Research Foundation are doing a highly effective job and have attracted to their support executives representing many of the leading industries of North America. In their capable hands may be left the task.

But what of labour? Until very recently labour has evinced little interest and with a few notable exceptions has demonstrated outspoken hostility to profit sharing.

Since the time of Samuel Gompers, unions have opposed any attempt to relate wages to profits and have abhorred any implication of responsibility in the profit-making process. Union leaders have insisted upon and re-enforced the economic concept of labour as a factor of production entitled to a fair wage for fair service arrived at by contract between employer and employee. The increasing power of unions and their federations has not changed this classic interpretation but has been used, rather, to make the process of wage determination more effective and has caused it to be codified in collective bargaining procedures protected and controlled by law. Unions have thus until recently resisted any suggestion of identity of interest with those of management or the investor.

Despite these generally held views, many unions have participated and do participate in successful profit-sharing arrangements, and there has been a growing tendency on the part of management and labour to experiment with innovations in remuneration. The introduction of production bonuses, pension and deferred compensation plans and the guaranteed annual wage have gone a long way to break down the clear distinction between direct wages for services rendered while employed and participation in the profits of enterprise.

Reuther's Declaration

In this context the announcement by Walter Reuther in January 1958 that his United Automobile Workers Union would seek a share of profits

as part of its 1958 contract demand may mark a major step forward.

While we must assume that Reuther's primary purpose is that of serving his own union members, we must also concede that in the process of framing his suggestions for profit sharing he may have been exposed to and was impressed by the basic principles and purposes of that philosophy. He must have been aware also that his advocacy represented a dramatic break with traditional union policy.

Profit sharing may thus represent the final emergence of a new concept of labour's participation in the processes of production. If Reuther is accepted as a spokesman, labour is in fact now claiming the right to be a partner in enterprise with a strong voice in the determination not only of wages but also of prices and the return upon investment.

Management and investor might look upon such proposals as pure effrontery were it not that a great many enterprises in Canada, the United States and Europe have largely adopted these principles and endorse their efficacy. Economists and industrial relations counsel also concede that recognition of labour's role as a partner in production has had beneficial economic results. There is reason to hope that acceptance by the major unions of full social and economic responsibility in industrial planning would be a help rather than a hindrance in the effort to maximize production.

In accordance with the old adage "If you can't beat them join them", management might also find in this new role of unionism an acceptable and stabilizing influence. Notwithstanding strikes and hard words in the bargaining procedure, contracts once signed have generally been honoured. The trend of wages has been alarmingly upwards but the existence of wage and performance agreements has introduced a high degree of order in the cost-price relationship and in the scheduling of production upon which management is enabled to plan. Furthermore as the labour force constitutes the largest identifiable segment of the consuming public we must acknowledge its interest in the equilibrium of wages, prices and profits. It may be no great step further to consider that sharing of profits with the labour force may be a most practical means for reconciling on a permanent basis the interests of labour, management and investor to the lasting benefit of all.

Such a consummation will require education and understanding on both sides.

Mutual Trust is Essential

The entire key to success is the establishment of mutual trust. Management must be prepared for frank revelation of its objectives, the formula for profit determination and the basis of distribution. On its part, labour must exhibit good faith and accept responsibility for unstinted performance. While management should be primarily concerned with greater economic achievement, experience indicates that it should also be imbued with a sincere desire to improve the remuneration and general status of the employee. The aim should be to foster in the employee a genuine interest and concern for the welfare of the enterprise.

In a free enterprise system the position of the investor must be protected and encouraged. Profit-sharing philosophy provides that before profits subject to distribution are deter-

mined, labour is entitled to the generally accepted standard of wages and capital is entitled to a fair return according to the generally accepted standard in similar ventures. After these first claims have been discharged, profits are then shared on the basis of risk taken on the one hand and measured productive improvement on the other. A number of case studies of situations in which these principles have been followed indicate that despite the allocation to labour of as much as 50% of profits thus determined the total and the percentage compensation paid to capital has exceeded the amount and percentage so paid before the introduction of profit-sharing.

Labour's Stake in Capitalism

There has been no indication that labour in Canada and the United States is fundamentally hostile to the legitimate functioning of capitalism. In fact, labour leaders have carefully eschewed being identified with the advocacy of any extreme form of socialism. Unions are well aware that our industrial progress is based upon the continued accumulation of capital and have in fact contributed substantially to the creation of investment funds. Profit sharing could further encourage this process by the direct issue of common shares, by the establishment of retirement funds, supplementary unemployment benefit reserves and similar methods for the accumulation of "deferred" profit sharing. Such funds together with those derived from actuarial pension plans, sickness and death benefit reserves and other social security measures have created a very considerable savings pool, directly or indirectly emanating from business profits but held in trust for the labour force. In one way or another, these cash resources are re-invested in the economy, thereby causing labour to inherit a basic interest in the stability and growth of the industrial plant.

Consciously or not, labour is acquiring "a stake in capitalism". If the process does not involve, and it need not, a deterioration of unionism in its historic role as spokesman for and protector of the rights of labour, neither labour nor investor has anything to fear. On the contrary, both may find in this new "democratic capitalism" an identity of interests which will be the surest bulwark against any form of sovietized industry.

Manager and investor may also take some comfort from the inference that profit sharing may counteract the tendency towards governmental control. The ultimate test of the private-enterprise system and of its right to be free is that it operate in the public interest. There can be no doubt that interest will be served best by a business community which produces efficiently and shares the benefits of that efficiency with labour and consumer and thus avoids political pressure for business regulation and social security measures.

Role of the Public Accountant

Undoubtedly long established prejudices and habits of mind must be overcome before universal acceptance of profit sharing would permit these benefits to be observed on a national scale. Management must forego distrust and recognize labour's interest in the methods and results of the productive process. The investor may be led to see that industrial harmony and greater productivity will result in the reduction of risk, the security of markets and the assurance of a fair return.

Labour must abandon the appearance of the class struggle and, if accepted as a partner in enterprise, must accept the responsibility of partnership to protect the interests of all groups endowed with an interest in the processes of production and distribution.

In the program of education intended to accomplish such results, the public accountant may perform an essential service. Our profession is recognized as having an objective interest in ethical business practices and industrial efficiency. We might serve our clients and our country well by studying the means by which profit sharing may be conceived and administered, without departing from an impartial role. In this we need make no apology for there is ample evidence at hand to support the contention that profit sharing properly understood and practised will provide a means to achieve the solution of labour-management problems, lower unit costs and create industrial peace upon which sound and profitable enterprise may thrive.

Professional Status

A profession cannot be created any more than a child can be born a full grown man. The roots must be deep, and to become full grown it must pass through the periods of testing and consolidation that form a heritage of ethics and standards that enable the members to impose tests of competence. It is a requisite that intellectual training be required, but there must also be a unique and specialized service rendered to society. A profession is underway when the practitioners build up an association and, with the members, erect the machinery for establishing recognition of responsibilities, standards of performance, and sharing of information.

The word "profession" has had a connotation of long standing that indicates a group that is separate and definitive. There are, of course, many more recognized professions today than in the past centuries; and, in a world of specialization, with world-wide communication and, more important, a desire for greater perfection, it seems likely that the trend to more recognized professions will continue.

—"Professional Status of Internal Auditing" by E. F. Ratliff, *The Internal Auditor*, December 1958.

Edited by W. BARRY COUTTS, C.A.

Accounting Research

British Pronouncements on Accounting and Auditing Practices

In the last month or two, there have been a number of official and unofficial British pronouncements on accounting and auditing matters. Canadian accounting and auditing practice has, in recent years, tended to follow American rather than British models. Our common background of company law and judicial precedent, however, ensures that the latter can never be entirely irrelevant.

Disclosure and Financial Statement Presentation

The Institute of Chartered Accountants in England and Wales, like other professional accounting bodies, has from time to time found it desirable to make formal pronouncements on accounting matters for the guidance of its members. The recent issue by this body of "Recommendation No. 18" concerning the "Presentation of Balance Sheet and Profit and Loss Account" gives an opportunity for comparing British standards with our own.

Recommendation No. 18 replaces a number of earlier recommendations, chiefly No. 8 issued in July 1944. The principal differences between the present recommendation and those which it supersedes are first, the elimination of all those prescriptions regarding form and content which are now covered by the United Kingdom Companies Act of 1948 and secondly, the inclusion of some general statements regarding the basic accounting principles underlying financial statements, especially with respect to those contentious questions arising out of the post-war inflation. The special problems created by consolidated statements are not covered in this recommendation, nor are those relating to income tax. Income tax problems have been dealt with separately in Recommendation No. 19 (discussed below). It is understood that the Institute is still considering whether or not to issue a revised recommendation on consolidations.

Because of the decision to avoid any duplication of the Companies Act provisions, the new recommendation deals chiefly with exceptional cases in which the general provisions of the Act are not appropriate or with those situations where more than the minimum legal disclosure is now considered desirable. The recommendation must, therefore, be read in conjunction with the relevant sections of the Companies Act, 1948.

As mentioned above, one of the most significant differences between the old and new recommendations is the increased space devoted to general pronouncements on the underlying philosophy of financial statement presentation. These statements are not only sufficiently universal in application to warrant quotation on their own merits, but they also demonstrate very forcefully the extent to which agreement on basic principles

has been achieved between the English Institute and our own.

In these preliminary remarks, it is said that the purpose of the balance sheet is to give a true and fair view of the state of affairs of the company on a particular date. This true and fair view is said to imply "appropriate classification and grouping of the items and therefore the balance sheet needs to show in summary form the amounts of the share capital, reserves and liabilities as on the balance sheet date and the amounts of the assets representing them, together with sufficient information to indicate the general nature of the items".

The recommendation further states: "A true and fair view also implies the consistent application of generally-accepted principles. Assets are normally shown at cost less amounts charged against revenue to amortize expenditure over the effective lives of the assets or to provide for diminution in their value. A balance sheet is therefore mainly an historical document which does not purport to show the realizable value of assets such as goodwill, land, buildings, plant, and machinery; nor does it normally purport to show the realizable value of assets such as stock-in-trade. Thus a balance sheet is not a statement of the net worth of the undertaking and this is normally so even where there has been a revaluation of assets and the balance sheet amounts are based on the revaluation instead of on cost."

With regard to the profit and loss account, the recommendation says: "The general aim of a profit and loss account should be to show a true and fair view of the profit or loss of the year, before and after taxation, based on the consistent application of recognized accounting principles. The account should be presented in a form which affords as clearly and readily as circumstances permit a comparison with the results of previous years.

"There are differing opinions as to what should be included in the amount shown as the profit or loss of a year. Some consider that it should take into account, subject to separate disclosure of material items in certain circumstances, all profits or losses arising or ascertained within the year, including those items which are the result of activities of the year and others which are the consequence, ascertained within the year, of transactions of earlier years. Others hold that the amount shown as the profit of the year should be restricted to the results of the operations of the year and that all other items should be excluded from the profit or loss of the year as being adjustments of earlier years and should be so shown in the profit and loss account.

"Each of these opinions has arguments in its favour and it cannot be said that either of them is generally accepted to the exclusion of the other. Provided that the account is prepared in conformity with either of these opinions and is the result of the consistent application of recognized accounting principles it can properly be said to be true and fair. If a change is made in the accounting principles applied and the effect is material, that fact and its consequences would need to be disclosed."

From these general statements, it is apparent that except for the optional inclusion of adjustments of prior years' operations and other special non-recurring items in the profit for the year, there are now no major differences of principle between

British and Canadian practice. Such a degree of agreement represents a considerable change from the position of a few years ago.

The profit and loss account of an English company was (and still is), in our terms, a combined statement of profit and loss and earned surplus. This fact, together with the practice of making frequent appropriations to reserves, has meant that in the past the English profit and loss account has often been a confusing mixture of trading profits, other income and expense, income taxes for various years, transfers to and from reserves, dividends, etc. Practice in this respect, encouraged by the English Institute's earlier recommendations, has been gradually changing and Recommendation No. 18, with its emphasis on the determination of a "profit or loss of the year" and the arrangement of the accounts to highlight this figure, thus marks the culmination of a long program of improvement. That there is still room for further improvement is suggested, however, by the indication in this recommendation as well as in Recommendation No. 19 that the deduction of taxes based on the current year's profit is still an optional requirement although strongly favoured by the leaders of the profession.

The detailed requirements of Recommendation No. 18 make the significance of this new concept very clear. It is stated that the profit and loss account should begin, unless turnover figures are disclosed, with the trading surplus or deficit for the year computed after charging depreciation and all other trading expenses. This is to be followed by other income and non-trading expenditures of the year to arrive at a balance which may be described as "profit before taxation". It is then recommended that there should be deducted from this amount a provision for taxation based upon the profit before taxation to produce a figure described as "profit after taxation". It is also provided that when the option of including non-recurring or other special items in the profit or loss of the year is chosen, full disclosure of all relevant particulars of such unusual items, including their effect on taxation, must be made.

It is interesting to note that the English Institute recommends that the disclosure of those special charges or credits which are taken into account in arriving at trading profit, but which must be shown separately for statutory or other reasons, should be accomplished by way of note or by inclusion in an unextended insert or "box" immediately following the figure of trading profit. The usual Canadian practice of beginning the statement of profit and loss under such circumstances with a meaningless figure of "profit before the charges set out below" is prohibited, at least by implication.

When a Canadian accountant looks at the provisions in Recommendation No. 18 regarding the balance sheet, his first reaction is likely to be one of confused dismay. Closer study, however, reveals that most of the apparent differences in standards of balance sheet disclosure are either matters of terminology or are related to the peculiar problems created by the United Kingdom system of income taxation. Even the "reverse order" of the British balance sheet does not actually involve any differences in principle as the essential framework of the balance sheet is the same.

Such a study does reveal, however, some differences in detail which perhaps should be discussed so that the possible applicability of the British proposals to our conditions can be considered. It is, for example, suggested that the use of the general headings "assets" and "liabilities" for the two sides of the balance sheet is unnecessary. This is perhaps not an important difference in viewpoint, but the suggestion does offer one solution to the problem of finding a satisfactory name for the "non-assets" side of the statement.

Another interesting question which is not without relevance to Canadian conditions is raised by the recommendation regarding the description to be applied to the sub-total representing the shareholders' interest in the enterprise. It is recommended that this sub-total, giving the aggregate of share capital, capital reserves (essentially contributed surplus), revenue reserves (appropriations of surplus), and the unappropriated balance of profit and loss (earned surplus) should be described factually by some such title as "capital and reserves". The use of "net worth" or some similar term is considered to be undesirable as "tending to suggest that a balance sheet purports to be a statement of values or to show the value of the undertaking. . . "

The fact that the struggle between replacement or renewal reserve accounting and depreciation accounting is not yet ended in Great Britain is apparent from several provisions such as the recommendation that the unused balance of the provision for renewals should not be deducted from fixed assets.

That the English Institute's recommendations on accounting for the increased cost of replacing fixed assets in the future has created problems is reflected in the recommendation that any additional amounts provided in respect of fixed asset replacement should be treated as "reserves" and not as provisions. Accumulations made in respect of inflationary increases in fixed asset replacement values must, in other words, be regarded as part of the shareholders' equity.

Two other minor points discussed in the recommendation could be relevant to Canadian conditions. With regard to the treatment of liabilities "secured otherwise than by the operation of law on any assets", it is recommended that the word "secured" should not be used without further amplification if there is evidence that the charge on the assets is for an amount less than the liability. This suggestion provides one solution to the problem of ensuring that the exact significance of the secured liability is understood by the reader of the balance sheet without going to the American extreme of naming the assets on which the liabilities are secured. The frequency with which the phrase "commitments for capital expenditure" appears in Canadian balance sheets also suggests that some consideration should be given to the English view that this term may have a wider significance than is actually intended. It is recommended that the phrase "contracts for capital expenditure" be used instead. It is suggested, however, that when this is done consideration should also be given to the desirability of disclosing, in addition, the estimated total expenditures involved in capital projects approved by the directors.

Treatment of Income Tax in Company Accounts

The whole scheme of United Kingdom income taxation is so different from the Canadian pattern that many of the specific problems discussed in Recommendation No. 19, "Treatment of Income Tax in the Accounts of Companies", do not arise under Canadian conditions. The general outlines of the problem are, however, the same and the solutions proposed in England are thus, in general terms, relevant to Canadian conditions. The most significant characteristic of the general conclusions is, in fact, the clear indication that, despite the special problems produced by the United Kingdom tax system, British opinion on these matters is moving towards a position almost indistinguishable from that of the Canadian and American authorities. A brief summary of some of the provisions of Recommendation No. 19 will illustrate the extent to which this trend to conformity has developed.

A large portion of the recommendation is devoted to a description of the scheme of United Kingdom taxation and the various problems which are presented to accountants by the fact that the taxation year seldom coincides with the fiscal year, and the fact that assessments are computed on the basis of the preceding year's profits and are payable prior to the end of the tax year. After discussing, and recognizing as acceptable, the various compromises which have been developed to deal with these problems, the Institute proceeds to express a strong preference for the practice of providing income tax each year based on the profit of the year.

This proposal, which has already been discussed above in connection with Recommendation No. 18, involves the recognition of a "provision" for taxes which are legally imposed in respect of a fiscal year which may not even have begun. Under these conditions it is not really surprising that the practice of recording only the taxes immediately payable has been so entrenched and the concept of "profit after taxes" so uncommon. It is greatly to the credit of the English accountants that they have managed to get such general acceptance of a proposal which involves recognizing anticipated liabilities as a proper deduction from the profit of the year.

The need to solve this basic problem, however, has simplified some related problems for English accountants. For example, once the general principle has been accepted that income taxes for the year must be related to the profits reported rather than to the taxes actually payable in the year, the special problems which arise when items subject to tax are excluded from reported profit can be very simply resolved. The principal example of this problem, the case in which the depreciation claimed for tax purposes differs from that deducted in the accounts, thus becomes merely one more specific application of the general rule. As a result, Part III of Recommendation No. 19 can deal quite briefly with a problem which has caused much heated discussion and debate in Canada and the United States. Most of the discussion, in fact, is devoted to the need for disclosing the amounts involved in those cases where the taxes recorded in the profit and loss for the year are not based on the profit for the year. The net result of the discussion is to recommend alternatives which place the English Institute in the position

taken by the C.I.C.A. Committee on Accounting and Auditing Research in Bulletin No. 10.

The Auditor's Responsibility for Inventories

Canadian practice with respect to the attendance of the auditor at physical stock-taking appears in recent years to have drawn nearer to the official American position. The extracts reproduced below from a speech by a prominent English accountant suggest that at least the beginnings of a similar trend may be developing over there.

The following extract is taken from the reproduction in *The Accountant* of October 11, 1958 of an address delivered at the autumn meeting of The Institute of Chartered Accountants in England and Wales. The speaker was Mr. Henry Benson, C.B.E., F.C.A., and his topic was "The Future Role of the Accountant in Industry".

"The next big change in audit practice must be in relation to stock-in-trade and, taken as a whole, I doubt whether our audit standards in this respect are high enough. For a long number of years too many of us have sheltered behind some of the passages in the judgment on the *Kingston Cotton Mill* case which was delivered in 1896, and quite insufficient attention has been given by auditors to the verification of the existence and the value of stock-in-trade and work in progress. Some auditors, even to this day, take no responsibility for stock and rely solely upon a certificate by the managing director. In my view this is indefensible and an auditor cannot properly sign the audit report required under the Ninth Schedule to the Companies Act if he has not taken proper steps to verify this asset.

"The auditor's failure to ensure that stock and work in progress is properly taken and valued for the purpose of the annual accounts has in many instances caused this asset to be wrongly stated. Not infrequently this leads to inquiries by the Revenue authorities and to costly and troublesome back duty investigations. Very often, moreover, when a private business is ready for flotation as a public company, the examination of the profits for past years shows that stock has not been properly valued with the result either that the issue has to be postponed or the investigating accountant's report has to include a damaging qualification. At present the auditor may or may not have a legal responsibility when situations such as these arise, but whatever the legal position he is certainly open to criticism in that he has failed to advise and guide his client wisely in matters which are essentially within his province as auditor. The time will inevitably come in the next few years when the auditor's duties in relation to stocks are again tested in the courts. When this happens it will be impossible for any member of the profession to come to the aid of a colleague whose defence is based primarily on the acceptance of a certificate given by the managing director as to the existence and value of stock-in-trade and work in progress.

"In those cases in which auditors do verify stock and work in progress, I suggest that the tests normally applied in this country should go further than they do at present. I think that the auditors should watch the annual or periodical stocktaking made by the company's officials. This is one of the best means by which the auditor can satisfy himself as to the phys-

ical existence of the stock and it is an admirable means of testing the system of internal check under which the stock is taken; of ensuring that all stock is included; and of verifying that slow-moving, obsolete, and redundant stock is properly excluded or written down to marketable values. If, when it is done, this observation of stocktaking is done thoroughly, I do not think that it need be carried out every year and it would be adequate in normal cases to do it once every four or five years."

Growth of Knowledge

The way in which knowledge provides control can perhaps best be illustrated by taking an example outside the business world. Consider, for instance, this contrast:

> Formerly, on small sailing vessels, the captain would exercise command by individually overseeing the entire ship's activity. Though his knowledge was substantial – though he knew the direction he was going, what each seaman was doing, the strength of the wind, and so on – there were many things he did not know. For instance, he did not know exactly where he was on the ocean, what weather was approaching in the distance, or what objects were just over the horizon. These unknowns were often of crucial significance.
>
> Modern ships have increased greatly in speed, range, size and power. They are far safer than in the past, and they get to their destination more rapidly and surely. Much of this progress is due to greater knowledge of the captain. Today the naval commanding officer has radar aloft, sometimes patrol planes ranging ahead to extend his knowledge of what is beyond the horizon, ship-to-shore radio, sonar equipment to detect what is under the sea, and so on. In short the *reach* of the commanding officer today is far beyond that of the sailing master in years past. He can project himself in terms of his knowledge far beyond his physical location or the people about him.

The analogy of the ship's captain has obvious parallels in management. The business executive needs to know daily where his business is, where it is going, and how much progress he has made in the desired direction each day. He needs to know these things not only for the office or plant around him that he can see but also for those parts of the enterprise far beyond his immediate location. He needs to know of impending dangers, what is beyond the horizon. And it is in exactly the same way as the sea captain – i.e. by enlarging his input of knowledge – that the modern executive extends his reach.

– "The Reach of an Executive" by Stahrl Edmunds, *The Harvard Business Review,* January-February, 1959.

Edited by CAMPBELL W. LEACH, C.A.

Tax Review

Federal Sales Tax

(This is the second of two articles devoted to a review of the federal sales tax system.)

Imported Goods

Imported goods are subject to sales tax on their "duty paid value". In determining whether imported goods are taxable the same rules apply as in the case of domestic merchandise. Tax is payable by the importer or transferee at such time as goods are taken out of bond, except when they are imported by a manufacturer or wholesaler under licence.

The form of the various certificates to be quoted by a licensee, depending on whether he is a manufacturer or wholesaler, and the purpose for which the goods are imported are given in Circular No. 1-C. As a matter of interest, it is observed that a licensed manufacturer may import free of tax goods which can be used in, wrought into or attached to taxable goods for sale, even though at the time it is known that the goods will be sold in the same condition as imported. If the goods are sold under taxable conditions, the manufacturer may account for sales tax at the time of sale on their duty paid value.

"Duty paid value" as defined in the Act means the value of an article as it would be determined for the purpose of calculating an *ad valorem* duty (i.e. graduated according to value) upon the importation of such article into Canada under the laws relating to the customs tariff whether such article is in fact subject to *ad valorem* or other duty or not, plus the amount of the customs duties, if any. Special or dumping duty is not included in the term "duty paid value" and is, therefore, not subject to sales tax.

Licensed Wholesalers

It is provided that a wholesaler may apply for a sales tax license if 50% or more of his sales for the three months preceding the application were exempt from tax. The principal advantage of a license to a wholesaler is that tax is paid at the time of sale rather than purchase or importation, and it also avoids the inconvenience of claiming refunds in respect of tax exempt sales. An unlicensed wholesaler is required to pay tax on the purchase price or duty paid value of goods at the time of acquisition.

A licensed wholesaler may also account for tax on the same base at the time of sale in one of two ways. The licensee may show on the office copy of each sales invoice the actual cost or duty paid value of each taxable item sold and recapitulate such costs and values monthly. However, this may be impractical in many situations. As an alternative, a licensed wholesaler may compute a discount factor to be applied to its monthly taxable sales to determine the taxable cost or duty paid value of the merchandise sold. The discount factor

or percentage is arrived at in the following manner:

> A reconstructed trading account statement is to be prepared covering the entire wholesale business for the two preceding years, by adding to the inventory, at the commencement of the period, the two years' purchases at cost and the duty paid value of imported goods, and deducting the inventory at the close of the period, thus determining the taxable cost of goods sold; deduct this figure from gross sales for the two-year period, and determine the percentage necessary to apply to sales to reduce them to taxable costs.
>
> At the close of each wholesaler's fiscal year, he is required to recalculate the percentage, to determine that to be used for the ensuing year, using the formula given above, omitting the oldest year's business, and substituting results of his business for the year just closed.

This method of accounting for tax is frequently preferred for its simplicity.

Sales at Less than Cost

It should not be overlooked that the regulations state that the tax is payable by the licensed wholesaler on the price paid for domestic goods and on the duty paid value of imported goods. If, because of depreciation, obsolescence or any other reason, the selling price is less than the purchase price or duty paid value, the tax must nevertheless be calculated on the intended base. When goods are sold by one licensed wholesaler to another, at a price less than their duty paid value or less than their purchase price, the vendor is immediately liable for sales tax on the difference.

Prepaid Freight

Licensed wholesalers are permitted to deduct freight prepaid by their suppliers when accounting for sales tax, as provided by the following extract from Circular No. 34-C:

> When calculating the sales tax payable on sales made on and after January 2, 1954, licensed wholesalers may deduct the freight prepaid by their suppliers on the goods, provided the amount of such freight is shown on the suppliers' invoices and the wholesalers have on file, for inspection by excise tax auditors, certified copies of the relevant freight bills.
>
> When licensed wholesalers use the discount method to determine the taxable cost of the goods sold, they may adjust the discount to be used on and after January 2, 1954, to the extent that they have on file certified copies of the freight bills paid by their suppliers for the two fiscal periods on which the dis- is based.

In certain instances, it may be worthwhile for licensed wholesalers to make arrangements with their suppliers to show the amount of prepaid freight on their invoices and to supply certified copies of the freight bills. Where the freight charges are paid directly by the licensed wholesaler, the adjustment for freight is simplified.

While on the subject of adjustments, it would seem as well to note that where a licensed wholesaler is selling goods at tax included prices, and granting tax allowances to customers on tax exempt sales, if he is accounting for tax under the "discount method", the discount factor may be adjusted to take this into account.

Rentals

Where a licensed wholesaler rents goods under exempt conditions, e.g. the goods are rented to a manufacturer or producer under the exemption for machines and apparatus used directly in the production of goods, the tax does not apply. If, however, the goods are subsequently sold under

taxable conditions, the licensed wholesaler must pay the tax on their cost or duty paid value as would have been the case had they been rented under taxable conditions in the first instance. Once the tax has been paid, no further tax is payable and no refunds are allowed on either subsequent rental or sale, even though, generally speaking, used or second-hand goods sold by licensed wholesalers are subject to sales tax.

Used or Second-Hand Goods

With the exception of the situation described above, unless used or second-hand goods are unconditionally exempt from tax or are sold under exempt conditions, e.g. to a provincial government, they are subject to sales tax if sold by a licensed wholesaler. This ruling embraces sales of warehouse, plant, or office equipment discarded by a licensed wholesaler and sales of "trade-ins".

Licensed Wholesaler Considered a Manufacturer

Where merchandise, such as suits, dresses, drapes, etc., are made up for a licensed wholesaler out of raw materials supplied and owned by him, he is regarded as the manufacturer thereof for tax purposes. Consequently, he is required to obtain a manufacturer's licence and to account for sales tax accordingly.

The foregoing review of the federal sales tax system has described the system in broad outline. In its application to the everyday operation of a business concern, it is probable that sales tax creates more than its share of problems, although in fairness it must be observed that frequently the problems arise as a result of too little attention to this tax. From time to time the Customs and Excise Division of the Department of National Revenue issues regulations on matters of procedure, the determination of "sales price" both generally and for particular "industries", etc. The regulations are issued in the form of circulars, of which Circular No. 1-C is of general interest, dealing as it does with freight and cartage, repairs, returns and payment of tax, goods lost in transit, the certificates to be quoted by licensees, etc. It is in these circulars that the sales tax system is embodied. As an indication of the type of information with which taxpayers are expected to be familiar, a few of the more common matters of general interest have been singled out for the following comments.

Freight and Cartage

Generally speaking, it is not intended that the "sales price" on which sales tax is paid should include freight or cartage charges. Regulation 21 of Circular No. 1-C provides that:

1. Where a manufacturer pays the sales tax on the actual selling price of his products, freight and/or cartage paid to independent carrier companies for transporting the merchandise from his factory, including shipments from branch(es), to the purchasers is not taxable, provided that freight so paid is shown as a separate item on the office copy of the sales invoice.
2. Where manufacturers avail themselves of a wholesale discount fixed by the Minister in which freight has already been calculated in the discount, no further deduction for freight or cartage may be taken.
3. Where a manufacturer is accounting for the sales tax on his wholesale price, established by sales to bona fide independent wholesalers, and such price includes freight, equivalent deduction may be made on account of the freight or cart-

age paid to independent carrier companies for transporting his goods to other purchasers, i.e. the price to independent wholesalers, less prepaid freight to them, is the wholesale price on which the tax is payable.

4. Where a manufacturer operates branch warehouses and accounts for the consumption or sales tax on transfer of his products to the unlicensed branch(es) on his established wholesale price calculated in accordance with the preceding paragraph, the freight or cartage paid to independent carrier companies for transporting the goods from his factory to such branch(es) may be deducted before computation of the tax. Where such manufacturers also sell from the branch(es) to wholesalers beyond the point at which the branch(es) is located and prepay freight to them, this would be deductible and equivalent freight paid on sales to other purchasers could also be deducted,
5. It will be necessary that freight referred to above be shown as a separate item on the office copy of the sales invoice and that evidence of payment to independent carrier companies by means of receipted freight or cartage bills be maintained on file for examination by excise tax auditors from time to time as may be required.
6. Retroactive adjustments or refunds on account of freight will not be permitted.

In addition to the foregoing and the comments previously made concerning freight charges and licensed wholesalers, the following miscellaneous rulings are worth bearing in mind:

1. A notation on the original or office copy of an invoice to the effect that "the above price includes freight charges and cartage, if any, amounting to $100" satisfies the requirement that to be deductible, freight must be shown as a separate item.
2. Where a manufacturer sells goods with an allowance for freight and deducts the amount allowed on his invoice, the tax may be computed on the net invoice price.
3. Where goods are sold "freight allowed" and the customer deducts the freight or cartage charges paid by him, tax may be computed on the net amount remitted. Where the vendor has accounted for tax on the full amount of the invoice, he may take credit for the adjustment on his next succeeding tax return.
4. Where goods are sold f.o.b. the place of shipment and the vendor pays the freight charges and cartage as a convenience to the customer and adds these charges to the amount of his invoice, sales tax need only be computed on the amount charged for the goods. However, where a manufacturer is accounting for sales tax on a wholesale price fixed by the Minister, care should be taken to see if the discount fixed by the Minister permits a deduction for freight. Sometimes it does not and, in these cases, the excise tax assessors will seek to tax the price of the goods plus any freight, even though the freight is paid by the vendor only to accommodate his customer and even if the freight is charged on a separate invoice.
5. Where a manufacturer sells his product at a delivered price and collects as a separate item the sales tax at the full rate on the invoice price, he is required to account for the tax so collected. He is not permitted to make any deduction for freight charges included in the delivered price even though it is noted on the office copy of the invoice, unless credit for the tax on the amount of the freight charges is given to the customer. In other words, the vendor cannot account for less tax than he collects from the customer.
6. Where a licensee finds it inconvenient to note the actual freight charges on the office copies of his sales invoices, he may apply to the Department to use a percentage deduction from his taxable sales in lieu of the actual freight charges paid. If permission is granted, the per-

centage will be based on the preceding twelve months' operations.

7. A charge made by a railway company for heating freight cars containing perishable goods in winter months may be treated as part of the freight charges in respect of which a deduction can be claimed.

To sum up, an adjustment for freight can often be made but only if two conditions are met. First, the freight and cartage must be paid to an independent carrier, e.g. cartage by a manufacturer's own trucks is not deductible for sales tax purposes. Secondly, the amount of the freight and cartage has to be shown on the original or on the office copy of the sales invoice, except where permission has been granted the vendor to use a specified percentage deduction.

Erection and Installation Charges

Persons, firms or corporations who manufacture and erect or install their products are required to be licensed and to compute and pay sales tax on the total charges made, less actual costs for erection and freight to the job where the freight is paid to independent carrier companies. Circular No. 1-C describes items which may be included in "erection costs".

Goods for Manufacturer's Own Use

Goods manufactured or produced by a manufacturer for his own use are subject to sales tax based on the selling prices of like goods. Where such prices have not been determined by sales by the manufacturer, the value will be fixed by the Minister in each case. Usually, in the case of machinery, etc., the value for tax is the cost of materials, plus productive labour, plus 100% of productive labour, plus 15% of the total to cover supervision and profit, the tax to apply on the overall total.

Sales tax does not apply to machinery and apparatus and complete parts thereof that, in the opinion of the Minister, are to be used directly in the process of manufacture or production of goods.

The value for sales tax purposes of small tools and miscellaneous items produced in a manufacturer's machine shop for his own use has been determined as the cost of the materials used plus labour at $2.00 per hour. Where the tools are to be used directly in the process of manufacture they are exempt from tax.

The test to be applied to determine whether sales tax is payable on goods which a manufacturer makes for his own use is whether they would be taxable if he purchased or imported the goods.

Machinery Rented by Manufacturer

There is no general ruling dealing with all cases where goods are leased or given out by manufacturers on a rental basis only.

Usually, in the case of machinery, etc., the value for tax is the cost of materials, plus productive labour, plus 100% of productive labour, plus 15% of the total to cover supervision and profit. If, in addition to leasing or renting, a manufacturer sells the same machinery in the ordinary course of business, the price at which the machinery is sold will serve as the "sales price" in accounting for tax where machinery is rented under taxable conditions. Second-hand machines, that are not re-built machines, are not subject to sales tax whether sold or leased, except when they are sold or leased by licensed wholesalers.

Where goods are leased under taxable conditions, sales tax is payable at the time when the goods are ship-

ped or delivered to the lessee and the tax must be remitted on or before the end of the month following.

Scrap and Waste

The sale by licensed manufacturers of scrap or waste produced in the process of manufacture, such as brass clippings, waste ends of fabrics, etc., to junk, scrap or rag dealers who do not have sales tax licences is subject to sales tax. Scrap or waste accumulated other than by the process of manufacture, e.g. broken-up plant equipment, may be sold free of tax.

Processing Materials

It is provided that "materials (not including grease or lubricating oils) consumed or expended directly in the process of manufacture or production of goods" are exempt from sales tax where the manufacturer gives the requisite certificate of use and quotes his licence number. Such processing materials will include washing compounds, detergents, polishing cloths, waste, etc., used for cleaning machinery or apparatus used directly in the process of manufacture or production, crayons (marking) and lacing thread used in the process of manufacture of boots and shoes, steaming wrappers for use in textile printing operations, etc.

Canadian Tax Foundation

The session devoted to federal sales tax at the recent annual conference of the Canadian Tax Foundation reviewed the practical problems of establishing a notional wholesale price for an industry, the lack of a satisfactory statutory definition of sale price and the absence of appeal procedures.

The basic weakness in our present sales tax system appears to be that the Excise Tax Act does not prescribe a realistic tax base on which to levy sales tax. The Act does not take cognizance of differences in price where a manufacturer sells like goods to wholesalers, retailers and consumers. If the letter of the law were followed, tax would be collected on the full selling price regardless of the customer. Consequently, the industry discounts permitted by the administration are *ultra vires*. Apparently it is next to impossible to so define sales price as to produce results which the industry discounts are designed to achieve, i.e. to have the tax apply to the price at which goods are sold or could be expected to sell to retailers.

It may be that, in the past, too much emphasis has been placed on drafting a definition that is both equitable and applicable in all circumstances whereas, for practical purposes, a less than perfect definition would suffice. Until the definition of sale price in the Excise Tax Act is amended, there is no statutory reference on which to base an appeal from either the rate of discount which the administration establishes for an industry or for a firm or the manner in which the regulations are administered.

The various opinions expressed at the conference would seem to indicate that the basic problems of the sales tax system are being crystallized. In time, it may develop that opinion will favour collection of sales tax on the price at which goods are sold to retailers, provided the rate is reduced appropriately. This would seem a logical development as it would appear that the wholesaler's role in the marketing system will continue to shrink in future and probably manufacturers will sell a much greater volume of goods directly to retailers than to wholesalers.

BY PETER C. BRIANT, M.B.A., C.A.

Current Reading

MAGAZINE ARTICLES

EQUIPMENT

"EDPM – Getting Past the Barriers to Success" by D. Ronald Daniel. *The Controller,* December 1958, p. 572 et seq.

The author of this article, a management consultant, identifies six underlying reasons that, in his opinion, account for the disappointing experiences with electronic computers, and shows how they may be overcome or eliminated entirely. The six barriers are:

1. The failure to establish genuine top-management interest and support of electronic data processing as a concept.
2. The inability to achieve an effective blend of existing company personnel with specialists hired from outside.
3. The absence of a realistic and workable relationship with the manufacturer of the electronic data-processing equipment.
4. The failure to recognize and promptly act on the organizational implications of electronic data processing.
5. The inability to effect the behaviour changes required to realize many of the potential advantages of electronic data processing.
6. The failure to anticipate the "disillusionment" that frequently develops during the first year of operation. It results from excessive optimism at the beginning.

Three conclusions emerge from the discussion of these six points: first, all are management problems and require management thinking and action; secondly, the barriers are such that recognizing them is the major step toward solving or avoiding them; thirdly, the six barriers are all inextricably related. The solution of one facilitates the solution of the others.

"Electronics – Its Impact on The Systems Profession" by Edmund G. Benser. *Systems & Procedures,* November 1958, pp. 2-5.

". . . The banding together of men in the systems field and the somewhat current development of electronic computers were coincidental. It may have resulted from the common knowledge that our economic system was expanding more rapidly than at any previous time and that there was need to prepare for the expansion. Oddly enough, there is not too close a relationship today between the developers of electronic equipment and those who are responsible for developing the systems which will use these tools. Also oddly enough, both groups have failed to some extent to grasp the real significance of what is happening.

"In other words, the developers of equipment are thinking primarily about the equipment and how it

stacks up competitively. Systems men, on the other hand, are working with the details of specific operating applications; whereas, the main problem exists at the top and broad level of the overall management of our economy..."

"CONSIDERATIONS IN EQUIPPING THE ACCOUNTANT'S OFFICE" by Lewis Bagaloff. *NAA Bulletin*, December 1958, pp. 57-58.

The most important factors to be considered in selecting equipment for an accountant's office are said by the author to be:

1. Simplicity of operation.
2. Speed of operation.
3. Original cost of the machine.
4. Portability.
5. Flexibility.
6. Durability.
7. Cost of training operators.
8. The seller and his policy towards trade-ins, etc.
9. Service and maintenance.
10. Adaptability of the machine to the existing system.
11. Operating cost, including: supplies, space occupied, special equipment needed, forms, repairs, power used, etc.

A full consideration of all the above factors, suggests Mr. Bagaloff, should guarantee a sound conclusion, resulting in the most economical return.

INTERNAL AUDITING

"THE INTERNAL AUDITOR – FRIEND OR FOE?" by A. J. Gregory. *The Internal Auditor*, December 1958, pp. 51-58.

"The [internal] auditor's concern with human relations is not restricted to those involving employees . . . There are a few instances . . . where his relations with outside firms can be important. The first of these concerns the company's public accountants . . . In the first place [internal auditors] can function as a liaison with other departments of the company and arrange for the preparation of the various schedules required by the public accountants. They can review these schedules and bring additions, deletions, or changes in accounts to the attention of the public accountants so that the required changes in schedules can be made. They can bring basic changes in accounting procedures to the attention of public accountants for their review. There are many auditing functions where the activities of the internal auditors tie in with the public accountant's operations. For example, some phases of inventory and cash audits may be performed by the internal auditors and observed by the public accountants. The confirmation of accounts receivable made by the public accountants may be referred to the internal auditors for an investigation of differences reported. To some extent, the value of work performed by the public accountants will be influenced by their confidence in the internal auditors. In order that they can become fully aware of the activities of the internal auditors, they should be furnished with a copy of the internal auditor's audit schedule at the beginning of each year and should receive a copy of each audit report as it is issued . . ."

MANAGEMENT SERVICES

"MANAGEMENT SERVICES BY C.P.A.'s" by Clinton W. Bennett. *The Accounting Review*, October 1958, pp. 602-614.

The growth of management services offered by public accounting firms is one of the most significant and inter-

esting developments in the profession in recent years. In this article, Clinton W. Bennett reviews the historical development of the subject, suggests reasons for the current interest in extending the practice of accounting beyond the traditional audit work and tax work, illustrates the breadth of problems the accountant may be called on to handle in management services practice, and advises his readers how the usual practitioner or accounting firm may develop such a practice.

On the last point, Bennett stresses that the thing not to do is for the practitioner to decide some morning that he is going to engage in management services, hire himself a staff of experts in various fields, and advise his clients that he is in the management services practice. This, he says, is the surest possible way of ending up with plenty of trouble. The first step, in his view, is for the firm to determine its clients' needs and to attempt to serve in those areas that are within its capacities. In some cases, new partners with specialized education and experience may have to be engaged. But Bennett has found that it is generally preferable to embark on an educational and training program to improve the effectiveness of present staff members.

The breadth of problems that an accountant may be called upon to handle in a management services practice is aptly illustrated by his case study involving the rehabilitation of a sick business. Any study of this type of problem includes the four areas of production, distribution, management, and economic prospect. Such work takes the accountant far outside the narrower confines of accounting *per se,* leading him into areas for which he will normally require specialized training and experience.

PRICING

"Pricing Objectives in Large Companies" by Robert F. Lanzilotti. *The American Economic Review,* December 1958, pp. 921-940.

Interviews with officials of 20 large American corporations reveal that realizing a particular rate of return on investment is the dominant objective governing pricing policies. In most cases, reports the author, achieving a target rate of return is regarded as a long-run objective.

Among the reasons cited for the increasing popularity of this pricing technique, the major influences seem to have been: (a) an increasing awareness of and concern by management for profit-capital-investment planning and capital budgeting; (b) the need for a common denominator for evaluating the performance of divisions and product groups in the large multi-product company; and (c) the emulation, by competitors and others, of successful companies such as du Pont and General Motors that have followed a target-return policy for many years.

Lanzilotti found, however, that no single objective or policy rules all price-making in any given company. In pursuit of policies that will yield the maximum satisfaction of the company's community of interests, one company will prefer stabilization of price and margin, another will seek to expand its market share, or to engage in continuous discovery and pre-emption of new fields, while others will be content to meet competition, to satisfy a set target, or to aim at combinations and variations of these goals.

PROFESSIONAL

"Reflections on American Auditing Procedure, Part II" by P. M. McCaw. *The Accountants' Journal*, October 1958, pp. 82-85.

Reflections on the status of the American auditor by a New Zealand accountant who spent two years in England employing American audit techniques: "The [American] auditor normally is regarded as much more than one who merely reports upon the accuracy of published accounts. He may be asked to express his opinion on specific aspects of company financial activities by means of answers to a questionnaire prepared by the company. He is often made responsible to management for pointing out failures by the company in carrying out procedural instructions as contained in its accounting manual. Often the auditor is the first person to whom the company turns for advice on the desirability or otherwise of changes in the system . . . In other words, he is regarded as being an independent adviser to the company.

"In this, the American auditor appears to have moved ahead of practice in other parts of the world . . . That he is in this fortunate position is due probably in no small part to his flexible and objective approach to his audit. His work is characterized by constant probing and enquiry. Because of his conviction that all financial information is useful audit material, even though to more orthodox minds it is not necessary to the audit, he soon acquires a sound knowledge of many aspects of the financial organization which the company will not be slow to appreciate. With this growing mutual confidence between auditor and client, the auditor's statutory duties are not only facilitated, but he also fulfils that highly useful and positive role in the community which, at least in the opinion of many, is to be expected of one who occupies such a unique position . . ."

BOOK REVIEW

"Dynamic Decade" by Eric J. Hanson; McClelland & Stewart Ltd., Toronto; 314 pages; $5.00

The theme of this book is the evolution and effects of the oil industry in Alberta. The author examines the profound changes that have taken place in the economy of the province from 1946 to 1956 — the dynamic decade — as the result of the dramatic development of its petroleum resources within this short period.

The author is Professor of Economics at the University of Alberta and this volume is basically a study in the economic field. In this respect, the techniques used to develop data for a regional economy are of special interest.

But this book is more than an economic study. It is also a fascinating history of the Canadian petroleum industry and a comprehensive exposition of the methods by which the industry operates.

All these elements have been skilfully blended into a book that will hold wide appeal.

Robert E. Waller, C.A.
Calgary, Alberta.

BOOK RECEIVED

"Bank Credits and Acceptances" by Wilbert Ward and Henry Harfield; The Ronald Press Company, New York; 277 pages; $7.00.

A discussion of American financing devices in relation to the trade transaction within the context of international practice as well as American law.

BY JOHN W. CROWE, C.A.

Administrative Accounting

Pensions and Registered Savings Plans

A contentious question for a number of years has been whether company pension plans should be contributory or non-contributory. The cost of contributory plans is shared by both company and employees, whereas non-contributory schemes are entirely financed by the company. By reason of the employee's contribution, the level of benefits under contributory arrangements will normally be higher than under non-contributory pension plans. Advocates of non-contributory plans argue that employees are guaranteed a basic minimum pension by the company and are free to supplement this by their own savings. If a portion of such savings is put into mutual funds or common stocks, employees will have a hedge against inflation not provided by normal pension plans. Moreover, the company is saved the task of administering what is in effect a separate pension plan for each employee. Proponents of contributory plans maintain that employees will not in fact save unless they are forced to do so. Moreover, the introduction in the early 1940's of income tax provisions, exempting from tax the amount of individual contributions to registered pension plans, added a further almost overpowering argument in favour of contributory pensions. Perhaps a majority of companies yielded to the pressure and introduced schemes of this nature.

However, with the recent introduction of registered savings plans into Canadian tax legislation, the argument for contributory pensions has become considerably less potent. While these provisions were primarily designed to overcome the difficulties faced by professional and other self-employed people in providing for retirement income, they also apply to employees of companies with non-contributory pension plans.

Registered Savings Plans

To a large extent the operation of registered savings plans and registered pension plans are parallel insofar as the employee is concerned. In both cases the upper limit on annual contributions is $1,500 (i.e. assuming the employee in the registered savings plan also is covered by a non-contributory pension), and the accumulated amounts are generally tied up for the specific purpose of providing an annuity or pension upon retirement. In the case of contributory pension plans, refunds of an employee's contribution are usually possible only in the case of termination of employment or death; refunds from a registered savings plan depending upon the particular contract may be more flexible. The rules for taxation of refunds are slightly different. The registered savings plan member's refund is taxed at 15% if it results from his death before maturity of the contract, and for any other reason at his marginal tax rate with a minimum of 25%. When a

member of contributory registered pension plans receives a refund under any circumstances, he may elect to be taxed at his average effective rate of tax in the preceding three years. Consequently, the member of the registered pension plan may enjoy some advantage over the owner of a registered savings plan contract in the matter of withdrawals, although where death is the cause of the refund a tax at the average rate of the three preceding years may be more than the 15% payable in the case of the savings plan.

A wide variety of avenues has been opened up since the introduction of the savings plan regulations by which the tax-free contributions may be accumulated for the eventual purchase of an annuity. Very little alteration was necessary in the government annuity contracts, but unfortunately the maximum annuity obtainable is still only $1,200 a year. By amending the terms of their policies to eliminate loan or surrender features, insurance companies have produced annuity plans that meet the new requirements. However, it has been the trust companies that have really taken advantage of the regulations. Plans have been devised that permit variations in annual contributions from very low minimums to the maximum allowable under the regulations and that provide a considerable choice in the methods of investing the contributions. Some of these plans guarantee the amount paid in plus interest at a guaranteed rate for the first five years while others are in the form of fixed debt funds, equity funds or a combination of both in which contributions purchase a share at the current unit value. In addition, most of the investment companies, both closed-end and mutuals, have instituted plans based upon the purchase of their shares, which qualify under the regulations. Some group plans, mainly for professional associations, have been worked out whereby the accumulation and investment of the funds are handled by a trust company. An insurance company provides the annuity at guaranteed rates upon maturity of the contract.

To illustrate some of the possible ways in which advantage can be taken of the registered savings plan legislation as well as the possible results in terms of retirement income, three examples are given below. In each of these cases it has been assumed that the participant is a married man, 40 years of age without children, has an annual income of $17,000 and will contribute $1,500 a year to a registered savings plan. Further, it is assumed that he will receive a pension of $5,000 at age 65 which has been entirely paid for by his employer under a non-contributory pension arrangement.

Case 1

Annuity plan (Assume money is accumulated in annuity at approximately 4%.)

Annuity at age 65 (premium of $1,500 a year from 40 to 65)	$ 5,300
Company pension	5,000
Retirement income	$10,300
Income tax at current rates	1,500
Net retirement income	$ 8,800

Case 2

Fixed debt plan — 5% Interest

Amount of $1,500 a year for 25 years at 5%	$71,600

Annuity purchased at age 65 (Cost of approximately $11,900 per $1,000)	$ 6,000
Company pension	5,000
	$11,000
Income tax at current rates	1,700
Net retirement income	$ 9,300

Case 3

Common stock plan – Return 7% (yield 5%–appreciation 2%)

Amount of $1,500 a year for 25 years at 7%	$94,900
Annuity purchased at age 65 (Cost of approximately $11,900 per $1,000)	$ 8,000
Company pension	5,000
	$13,000
Income tax at current rates	2,300
Net retirement income	$10,700

Since the employee in the example is in the 38% tax bracket, his net annual contribution toward retirement is not $1,500 but only $930. For this relatively modest contribution in relation to his income, he accumulates a substantial pension no matter which alternative he chooses.

While the risk may be greater it is probable that a higher return over the long haul and some protection against inflation can be achieved by buying common stocks. The Cowles Commission calculated that over a period of 68 years ending in the middle of the great depression in the 1930's, the average annual return on the representative group of industrial common stocks was 8.1%, composed of dividends of 5.3% and appreciation of 2.8%. Similarly the dividend yield on the Dow-Jones industrial average over the last 50 years has been more than 5% and the annual rate of appreciation has approached 3%.

It is reasonable to suppose that registered savings plans which include a substantial portion of common stocks will provide opportunities to combat the effects of inflation and share in the growth of Canada in a way not available to employees under contributory pension plans where investment policies must of necessity be rather conservative. A non-contributory pension plan gives employees an exceptional opportunity to take advantage of this situation. An employee is guaranteed from his company-paid pension a retirement income of at least subsistence level. He can therefore afford to accept some of the risks inherent in common stock ownership especially when the government (through tax reductions) is putting up part of the money.

Comparison of Registered Savings Plans with Private Investment

The obvious powerful advantage of a registered savings plan over any non-registered plan is that the contributions are allowed as deductions from taxable income. For a man earning $10,000 a year the government's share of his annual contribution to a registered savings plan is 24%, for a man earning $17,000 it is 38% and for a man earning $25,000 it is 43%. Are there any disadvantages?

Let us consider a man age 40 who is planning to accumulate his savings largely through the medium of common stocks. If he follows a non-registered plan he can take advantage of the 20% credit for dividends and will pay no tax on capital gains. If he uses a registered plan, while he will get substantial assistance in tax relief in making his annual contribu-

tions, he will finally have to pay tax on the full amount of a terminal annuity. In other words, his dividends and capital gains will eventually become taxable. If he withdraws his money from a registered plan at any time he must pay tax at his marginal rate in that year or 25%, whichever is higher. Moreover, at age 71 under a registered plan accumulated savings must be invested in a fixed annuity. A non-registered accumulation can be left indefinitely in equity investments.

In the examples below, an attempt is made to illustrate the relative importance of some of these factors.

	A	B	C
Income at age 40	$10,000	$17,000	$25,000
Registered plan (common stock):			
Annual gross contribution*	$ 1,000	$ 1,500	$ 1,500
Accumulation at age 65:			
Dividends at 5% per year	$47,700	$71,600	$71,600
Dividends at 5%, appreciation at 2% per year	63,200	94,900	94,900
Non-registered plan (common stock):			
Marginal income tax rate	24%	38%	43%
Comparable annual contribution	760	930	855
Accumulation at age 65:			
Dividends at 5% (after tax)	$35,300	$38,700	$31,200
Dividends at 5% (after tax); and appreciation of 2% per year	46,700	51,000	40,800
% of accumulations under non-registered plan to registered plan (approx.)	75%	55%	45%

*In all cases it has been assumed that the individual is a member of a registered pension plan and that his contribution is therefore limited to 10% of income up to a maximum of $1,500.

As one would expect, the accumulation of funds under a registered plan far exceeds that under a non-registered plan. A $10,000 man can accumulate 1/3 more than under a non-registered plan with comparable contributions. For a $25,000 man the registered accumulation is more than double that of a non-registered plan. However, if the funds are used to buy an annuity the entire annual receipts are taxable under a registered plan whereas only the interest portion is taxable under the non-registered arrangement. For a life annuity purchased at age 65 the interest portion is about 20% of the annuity. In other words, a registered annuity is fully taxable whereas only one-fifth of a non-registered annuity is subject to tax. It can be readily seen, however, that tax rates at retirement age would have to be very high indeed for the balance of advantage to swing in favour of a non-registered plan.

For the man earning $10,000 in the above example, it can be calculated that unless his effective retire-

ment tax rate exceeds 30% he is further ahead to have a registered plan. For the man earning $25,000 the effective retirement tax rate would have to exceed 65% to make a non-registered plan advantageous. Suffice it to say that unless effective retirement income tax rates are substantially higher than the average rates paid during a man's working life, a registered plan will produce a better annuity upon retirement than a non-registered one. Since the retirement income of man will generally be much lower than his working income we would normally expect his effective retirement rate of income tax also to be lower. The forecasting of future income tax rates, however, is at best a guessing game.

One perhaps unnecessary restriction that the government has imposed in respect of registered savings funds is that they must be used to purchase a fixed annuity prior to age 71. The decision to permit the accumulation of savings for retirement in the form of equity funds has not been carried through to its logical conclusion. If it is recognized that, through fear of inflation and a desire to share in the expansion of the country, people are willing to accept the risks of common stocks should they not be permitted on retirement to leave their investment in that form? As has been proven in other cases, principally by the college retirement equities fund, it is perfectly feasible to establish an annuity whereby a certain number of units are withdrawn each year and these valued in relation to current stock prices and dividend income of the overall fund. In this manner the inflation protection available during the years of saving would continue throughout the retirement period.

With registered savings plans available, individuals who are members of non-contributory pension plans can have all the advantages of a contributory pension plan and much greater flexibility. They are in a position to take at least partial advantage of variable annuity principles. Companies with non-contributory plans might investigate the various registered savings plans available and perhaps allow deductions from employee earnings for contributions to a selected few.

BY J. E. SMYTH, F.C.A.

Students Department

Associate Professor, Queen's University

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problems as will make their study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, October 1957

Accounting II, Question 6 (15 marks)

On June 30, 1956, H Co. Ltd. acquired 95% of the capital stock of J Co. Ltd. and 90% of the capital stock of K Co. Ltd.

During the six months ended December 31, 1956, the three companies reported net profits as follows:

H Co. Ltd.	$22,000
J. Co. Ltd.	6,000
K Co. Ltd.	5,000

There were no changes in the capital stock of the three companies during the six months ended December 31, 1956.

On December 31, 1956, the following dividends were paid for the year ended on that date:

H Co. Ltd.	$12,000
J Co. Ltd.	4,000
K Co. Ltd.	6,000

The dividends received by H Co. Ltd. from the two subsidiaries had been credited to the revenue account "Income on investments".

The condensed balance sheets of the three companies as at December 31, 1956 are shown on the attached columnar sheet.

Required:

Complete the work sheet for the consolidated balance sheet as at December 31, 1956 (Submit calculations supporting each eliminating entry recorded on your work sheet.)

***Editor's Note*: Candidates were provided with a columnar work sheet which included the following data in the left hand columns:**

Condensed Balance Sheets — as at December 31, 1956

	H Co. Ltd.	J Co. Ltd.	K Co. Ltd.
ASSETS			
Current assets	$108,700	$ 44,000	$ 9,000
Fixed assets — net	135,000	150,000	85,000
Goodwill	—	—	6,000
Investment in subsidiaries, at cost:			
J. Co. Ltd.	156,000		
K Co. Ltd.	85,000		
	$484,700	$194,000	$100,000
LIABILITIES			
Current liabilities	$ 54,000	$ 35,000	$ 5,000
Capital stock, par value $100	350,000	150,000	60,000
Earned surplus	80,700	9,000	35,000
	$484,700	$194,000	$100,000

A SOLUTION

(For worksheet see page 158)

H CO. LTD.
Working Papers for Preparation of Consolidated Balance Sheet December 31, 1956

Adjustments and Eliminations		Dr.	Cr.
(1) Capital stock — J — 95% of $150,000		142,500	
Earned surplus — J — 95% of (9,000 — 6,000 + 4,000)		6,650	
Goodwill		6,850	
Investment in shares of J Co. Ltd.			156,000
To eliminate equity acquired by H Co. Ltd. in J Co. Ltd. as of June 30, 1956.			
(2) Capital stock — K — 90% of $60,000		54,000	
Earned surplus — K — 90% of $35,000		31,500	
Investment in shares of K Co. Ltd.			84,100
Goodwill			1,400
To eliminate equity acquired by H Co. Ltd. in K Co. Ltd. as of June 30, 1956, with Earned surplus and Investment accounts adjusted for the subsequent payment of dividends out of acquired surplus.			
(3) Earned surplus — H		900	
Investment in shares of K Co. Ltd.			900
Adjustment for subsequent payment of dividends out of surplus of K Co. Ltd. acquired as of June 30, 1956:			
Profits of K Co. Ltd. for six months ended Dec. 31, 1956	$5,000		
Dividend paid by K Co. Ltd.	6,000		
Adjustment — 90% of	($1,000)		

A SOLUTION

H. CO. LTD.

Work Sheet for Consolidated Balance Sheet as at December 31, 1956

	Condensed Balance Sheets — Dec. 31, 1956				Adjustments and Eliminations		Consolidated Bal. Sheet
	H Co. Ltd.	J Co. Ltd.	K Co. Ltd.	Total	Dr.	Cr.	Dec. 31, 1956
ASSETS							
Current assets	108,700	44,000	9,000	161,700			161,700
Fixed assets — net	135,000	150,000	85,000	370,000			370,000
Goodwill			6,000	6,000	(1) 6,850	(2) 1,400	11,450
Investment in subsidiaries at cost:							
J Co. Ltd.	156,000			156,000		(1) 156,000	—
						(2) 84,100	
K Co. Ltd.	85,000			85,000		(3) 900	—
	484,700	194,000	100,000	778,700			543,150
LIABILITIES AND CAPITAL							
Current liabilities	54,000	35,000	5,000	94,000			94,000
Capital stock, $100 par value:							
H Co. Ltd.	350,000			350,000			350,000
					(1) 142,500		
J Co. Ltd.		150,000		150,000	(4) 7,500		—
					(2) 54,000		
K Co. Ltd.			60,000	60,000	(5) 6,000		—
Earned surplus H Co. Ltd.	80,700			80,700	(3) 900		
					(1) 6,650		
J Co. Ltd.		9,000		9,000	(4) 450		81,700
					(2) 31,500		
K Co. Ltd.			35,000	35,000	(5) 3,500		
Minority interest — J Co. Ltd.						(4) 7,950	7,950
— K Co. Ltd.						(5) 9,500	9,500
	484,700	194,000	100,000	778,700	259,850	259,850	543,150

(4) Capital stock — J — 5% of $150,000	7,500	
Earned surplus — J — 5% of $9,000	450	
Minority interest in J Co. Ltd.		7,950
To record minority interest in J Co. Ltd. as of December 31, 1956		

(5) Capital stock — K — 10 % of $60,000	6,000	
Earned surplus — K — 10% of $35,000	3,500	
Minority interest in K Co. Ltd.		9,500
To record minority interest in K Co. Ltd. as of December 31, 1956.		

Examiner's Comments

Some candidates treated dividends paid at the end of the year as payable, and entered the payment on the work sheet "pro forma".

PROBLEM 2

Intermediate Examination, October 1957

Auditing I, Question 6 (12 marks)

In reviewing the internal control in a specialty shop selling furs, women's clothing and accessories, CA discovers the following:

(i) There are cash registers for cash sales throughout the store. All payments on charge accounts must be made to the general office cashier. Pre-numbered duplicate receipts are issued when a payment is received for the credit of any charge account, whether the payment is by cash or by cheque. When not busy at the cash wicket, the cashier helps with the posting of the accounts receivable ledger.

(ii) Customers frequently pay their accounts with cheques of larger amounts than owed to the store and receive the excess in cash.

(iii) Sales clerks are authorized to issue credit notes from pre-numbered pads on the receipt of returned merchandise. The credit notes may be either cashed at the general office or applied against further purchases.

(iv) Sales made on charge accounts are written up by the sales clerks on pre-numbered duplicate invoices. Copies of each day's charge invoices, together with any credit notes issued, are sent to the general office daily.

(v) Cash registers at each counter are kept locked and the office manager "clears" them and balances the cash at the end of each day. Sales clerks frequently use cash registers other than the one at their own counter when helping out another counter during the rush and lunch hours.

Required:

For each of the procedures listed above, state what revisions, if any, should be made to remedy any deficiencies in the system of internal control.

A SOLUTION

Revisions Required to Remedy Deficiencies in System of Internal Control

(i) The practice of having the cashier assist with the posting of the accounts receivable ledger should be discontinued if the danger of "lapping" is to be avoided. The cashier should have no duties with respect to the receivable records.

(ii) The practice of accepting cheques from customers in excess of the amount owed, and of paying the excess back in cash, should be discontinued. It complicates the control on remittances received in the form of cheques and permits cash payments without approval. Cheques cashed for customers should be approved by the credit manager.

(iii) The procedures used for issuing credit notes for returned merchandise do not guard against the issue of fictitious credit notes, and permit cash refunds on charge account merchandise. All credit notes should be signed for receipt of merchandise and approved by a responsible employee. Only designated employees should be authorized to sign credit notes. No cash refunds should be made on credit notes issued for the return of charge account merchandise.

(iv) The procedure described is adequate, and no revision is necessary.

(v) In the procedure used, the office manager has access to both the cash receipts and the original record of the receipts (the cash register tapes). A better procedure is to have the cash receipts sent each day directly to the general cashier who makes up the bank deposit and deposits the receipts in the bank. The general cashier would prepare a daily report of cash receipts by registers and the office manager would then check this report with the totals of the cash register tapes. The practice of permitting sales clerks to use other cash registers should be discontinued because it makes it impossible to identify the particular clerks who are responsible for cash shortages and overages.

PROBLEM 3

Final Examination, October 1957

Accounting III, Question 4 (22 marks)

As a result of extensive expansions in its operating facilities, K Co. Ltd., a medium-sized manufacturing concern, is faced with the problem of securing outside financial assistance. Management has suggested that it might be advisable for the company to enter into a sale and leaseback contract on the company's property rather than to issue bonds or obtain a mortgage loan.

Management has asked CA, the shareholders' auditor, to assist in the preparation of a brief on the proposed financing for presentation to the shareholders. They advise CA that a contract could be made with one of the large life insurance companies to purchase the company's property at its present book value, $250,000, consisting of buildings worth $200,000 and land worth $50,000. The leaseback contract would call for annual rental of $19,000 for an initial period of 25 years and renewal periods extending for a

further 20 years. All expenses relative to the buildings are to be paid by the lessee.

For the purpose of considering the sale leaseback arrangement, manage- asked CA to compare this method of financing with a mortgage loan or bond issue of $250,000 repayable in 25 annual instalments of $10,000, with interest payable at 5% per annum. Over the 25 year period, interest payments would amount to $162,500.

Depreciation of the company's buildings is taken at 5% on the diminishing balance method and over a 25 year period this method would reduce the book value of the buildings by 72.26%.

Required:

(12 marks) (a) The general advantages and disadvantages of the use of sale and leaseback contracts as a financing medium, which CA should suggest that management bring to the shareholders' attention.

(10 marks) (b) Statements or schedules for presentation to the shareholders contrasting the cash flow and the effects on net profits over a 25 year period of:
- (i) proposed sale and leaseback contract,
- (ii) bond issue or mortgage loan.

NOTE: *Students may assume an income tax rate of 47% over the 25 year period.*

A SOLUTION

(a) Advantages and Disadvantages of the Use of Sale and Leaseback Contracts as a Financing Medium

Advantages

1. This type of contract makes it possible for management to maintain an adequate level of plant facilities without impairing working capital, and without experiencing the restrictions of other financing methods. The decision to sell a property under a leaseback plan should of course be based on a conviction that the working capital thus provided can be put to and maintained in profitable use.
2. The leaseback arrangement presents a possible means of effecting tax savings. The total annual rental paid to the lessor may be deducted as an expense. If, instead, the tax-paying company owned its facilities, it could deduct for tax purposes only the aggregate of interest on borrowed capital and capital cost allowance on its depreciable plant and equipment. In calculating tax liability it is possible to report the cost of using assets more rapidly under the leaseback plan than under the system of recording depreciation on owned facilities. The annual rental charges also cover the cost of the land, which is not taken into account in calculating capital cost allowances.
3. The leaseback plan offers a means of avoiding obsolescence. The ability to sub-let properties which no longer effectively fulfil their function for the company provides management with an escape from the threat of having

the company at some future time holding property which has become obsolete.

Disadvantages

1. The leaseback contract usually contains clauses which prevent the lessee from making changes or additions to the property without obtaining the consent of the lessor. These requirements may sometimes inhibit a completely free use of the assets.
2. The arrangement is continuously subject to the possibility that the lessee will be dispossessed at the termination of the lease.
3. Leasing may be more expensive than ownership.
4. The lessee is subject to the dangers of financial instability on the part of the lessor. If the lessor should fail, the lessee company must accept a new landlord and be ready for litigation if necessary to protect its rights.
5. The prestige inherent in ownership is absent in the leaseback arrangement.

(b) **K CO. LTD.**

EFFECT OF ALTERNATIVE FINANCING METHODS ON CASH FLOW AND NET PROFITS OVER A TWENTY-FIVE YEAR PERIOD

	Sale and leaseback		Mortgage or bonds	
	Cash flow	Effect on profits	Cash flow	Effect on profits
Rental	$475,000	$475,000	–	–
Repayment	–	–	$250,000	–
Interest	–	–	162,500	$162,500
	475,000	475,000	412,500	162,500
Deduct depreciation expense not recorded under sale and leaseback plan	–	144,520	–	–
	475,000	330,480	412,500	162,500
Deduct Tax reduction related to additional expense (47%)	155,326	155,326	76,375	76,375
Net effect	$319,674	$175,154	$336,125	$ 86,125

Examiner's Comments

1. Some candidates confused a sale and leaseback contract with a hire-purchase agreement.
2. A number of candidates failed to understand the ways in which the effect on net profit may differ from the effect on cash flow.

NEWS OF OUR MEMBERS

Alberta

P. Hanhart, C.A. announces the opening of an office for the practice of his profession at 308 — 9th St. S., Lethbridge.

A. Young, C.A. announces the formation of a partnership with R. M. Parkyn, C.A. and T. G. McNab, C.A. The partnership will be known as Young, Parkyn & McNab, Chartered Accountants, with offices at 220 British Canadian Trust Bldg., Lethbridge.

Ian Kennedy, C.A. has been appointed secretary-treasurer of Okanagan Helicopters Ltd.

British Columbia

A. P. Gardner & Co., Chartered Accountants, and Geoffrey Harris, C.A. announce the amalgamation of their practices. The partners in the new firm will be A. P. Gardner, C.A., T. F. Rose, C.A. and G. Harris, C.A. The new firm will continue in the name of A. P. Gardner & Co., Chartered Accountants, with offices at Terrace and Kitimat.

Anton Miachika, C.A. announces the opening of an office for the practice of his profession at No. 518, 1030 West Georgia St., Vancouver 5.

W. R. Beacom, C.A. announces that he has severed his connection with the firm of Chadwick, Beacom & Co., Chartered Accountants, and that he has opened an office for the practice of his profession at 26 Lorne St., New Westminster.

Colin E. C. Stewart, C.A. has been appointed plant controller of Western Copper Mills Ltd., Annacis Island.

Ian R. A. Mills, C.A. has been appointed director of finance for the B.C. Power Commission.

Manitoba

S. B. Laing, C.A. has been appointed comptroller and chief accountant, French Petroleum of Canada Ltd., Calgary.

Gilman, Burke, Newman & Co., Chartered Accountants, announce the removal of their offices to 507 Lindsay Bldg., Winnipeg 2.

D. H. Wheeler, C.A. comptroller, The Ogilvie Flour Mills Co. Ltd., Grain Div., addressed the Winnipeg Chapter of the National Office Management Association on December 15, 1958.

Nova Scotia

Peat, Marwick, Mitchell & Co., Chartered Accountants, and Johnson, Smith & Co., Chartered Accountants, Halifax, announced that their practices have been combined and will be carried on as Peat, Marwick, Mitchell & Co.

Ontario

Duckman, Kurtz, Resnick & Co., Chartered Accountants, 12 Richmond St. E., Toronto, announce the admission to partnership of Irving Rosen, C.A., M. M. Papernick, C.A. and C. M. Zeifman, C.A.

Henry Glover & Co., Chartered Accountants, Toronto, announce the admission to partnership of F. R. Balmer, C.A.

A. R. MacCallum, C.A. has been appointed a director of the American-Standard Products (Canada) Ltd., Toronto.

A. R. Marchment, C.A. has been appointed secretary-treasurer of Pacific Finance Credit Ltd.

Ross, Touche & Co., Chartered Accountants, announce the removal of their Toronto offices to Bank of Canada Bldg., 250 University Ave.

E. C. Direnfeld, C.A. and Oscar Fisher, C.A. announce the formation of a partnership for the practice of their profession under the name of Direnfeld, Fisher & Co., with offices at 21 Dundas Square, Toronto.

Quebec

Irving London, B.Com., C.A. announces the removal of his office to 3448 Peel, Montreal 2.

E. H. Veinish, C.A., a partner in the firm of Veinish, Blauer & Co., Chartered Accountants, addressed the meeting of the Society of Industrial and Cost Accountants, on "The effect of changing dollar values on replacement costs".

W. F. White, B.Com., C.A. has been appointed comptroller and secretary of Standard Telephones & Cables Mfg. Co. (Canada) Ltd., Montreal.

INSTITUTE NOTES

B.C. INSTITUTE

Convocation — January 15, 1959: Sixty-nine of the 73 successful candidates in the 1958 final uniform exams received membership certificates at the convocation held in Brock Hall on the U.B.C. campus on Thursday, January 15, 1959. Membership in the Institute now totals 997.

Convocation speaker was Hon. Frank Mackenzie Ross, C.M.G., M.C., K.St.J., LL.D., Lieutenant-Governor of the Province of British Columbia. C.I.C.A. president John H. Helliwell, and representatives from the University of British Columbia, assisted with the awarding of prizes and certificates.

On February 2, J. O. St. Clair-Sobell, Ph.D., head of the Department of Slavonic Studies, speaks on his experiences at the Fourth International Congress of Slavists held in Moscow from September 1-10, 1958.

Hon. Ray Williston, Minister of Lands, Forests and Mines, is scheduled to speak on March 2.

C.A. Wives Club — Vancouver Chapter: The C.A. Wives Club held a luncheon meeting on January 28, 1959, at Capilano Gardens, Park Royal, West Vancouver. The speaker was Robertson D. Noble, chairman of the 1959 C.I.C.A. Conference Local Arrangements Committee, who outlined plans for the 57th annual conference to be held in Vancouver from September 13 to 16, 1959.

1959 C.I.C.A. Conference: During the visit to Vancouver in December 1958 of J. R. M. Wilson, chairman of the C.I.C.A. Annual Conference Committee, a series of organizational meetings for the 1959 C.I.C.A. conference were held. The following Local Arrangements Committee has been set up:

Chairman: Robertson D. Noble.

Sub-Committee Chairmen:

Registration & Statistics: W. D. Lennox (Price Waterhouse).

Hotel Reservations: G. W. Woods (Western Canada Breweries Ltd.).

Publicity: D. W. G. Smallbone (Peat, Marwick, Mitchell & Co.).

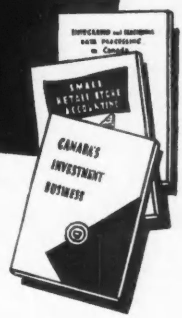
Transportation: Tom Chambers (B.C. Electric).

Entertainment and Refreshments: Don Corbett (Perco Industries Ltd.).

Ladies: Mrs. Ian H. (Pat) Bell (C.A. Wives Club president).

Continued on page 166

* *How to Obtain* C.I.C.A. Publications Immediately on release



Last year The Canadian Institute of Chartered Accountants planned a permanent mailing list to help its members obtain publications easily.

Those on the list are sent every publication when issued and saved the trouble of having to place a separate order each time a new book or brochure is published. They are also assured of receiving copies of new publications immediately after release.

Already 350 individuals and companies have listed their names with the Institute and have been receiving its interesting and informative publications.

So far a variety of subjects have been covered such as grain accounting, accounting for the forest product industries, integrated and electronic data processing, municipal finance, Canada's investment business. The latest to appear this month is accounting for the small retail store. More brochures are planned for publication later this year.

You are invited to enter your name on the permanent mailing list and receive the Institute's publications as they become available (averaging three per year). The only cost to you is the regular price of the publication. There is no special charge for this service.

Take advantage of this service by mailing the coupon below:—

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Please enter my name on the permanent mailing list, starting with "Small Retail Store Accounting" (price $1.25). I expect to receive Institute publications as they become available (averaging 3 per year).

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C.I.C.A. PUBLICATIONS

(For description of publications see page opposite)

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Continued from page 164

These members will work in liaison with the C.I.C.A. Annual Conference Committee, whose local representatives are Alex Campbell and George Cumpston, and with the Executive Committee of the B.C. Institute. Please be alert to any calls for assistance which will be made, as the staging of a C.I.C.A. conference has developed into a large-scale enterprise requiring the support of many local members. Remember the conference dates — September 13 to 16.

ONTARIO INSTITUTE

***Officers and Council*:** As a result of the death of J. G. Brown, F.C.A., vice president, elections were held to fill the vacancy in the executive, and on December 16, the following officers were elected: R. B. Dale-Harris, F.C.A., vice president; W. J. Ayers, F.C.A., secretary; T. C. Kinnear, F.C.A., treasurer. G. H. Ward of Ward, Welch, Hall & McNair, Toronto, was elected to fill the vacancy on the Council.

***Presentation of Certificates*:** The ceremony of presenting membership certificates to the 211 successful candidates of the 1958 examinations will be held in the concert hall of the Royal York Hotel, Toronto, on Friday, February 13, 1959, at 3:15 p.m. Mr. J. G. Glassco, O.B.E., F.C.A., vice-president of Brazilian Traction Light and Power Co. Ltd., will give the address of welcome to the new members. Mr. Glassco is a past president of both the Canadian and Ontario Institutes of Chartered Accountants. The number of graduates is the largest in the history of the Institute.

***Affiliates*:** The following have been admitted to membership by affiliation: John B. Atkinson (Que. '38), William H. Bailey (Alta. '29), Robin W. Butler (Eng. '58), Keith C. Cardiff (Alta. '52), Douglas A. Clarke (Eng. '27), Gene D. Dennis (P.E.I. '56), Colin G. B. Faulkner (Eng. '56), Thomas S. G. Flett (Scot. '56), John H. Freke (Eng. '52, N.B. '56), Roy E. Hedmann (Eng. '58), George S. Henderson (Scot. '53), Jacques Latremouille (Que. '57), Spenser S. MacIntosh (N.S. '47), Griffith M. Marshall (Que. '53), Vincent A. Patenaude (Que. '58), Theodore Rhenius (Eng. '56), William G. Russell (Alta. '56), Alan D. Stickler (Eng. '50), James E. C. Wallace (Scot. '57).

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76th Anniversary Dinner: Friday, March 13, 1959, will be the date of the next annual dinner of the Institute which will be held in the Royal York Hotel, Toronto. Mr. J. D. Gibson, general manager of the Bank of Nova Scotia, Toronto, will be the guest speaker.

Library: Recent additions are — "Deloitte & Co. 1845-1956" Oxford University Press. "High Speed Data Processing" by Gotlieb & Hume, McGraw Hill & Co. "Principles of the English Law of Contract" by W. R. Anson, Oxford University Press. "Essentials of Accounting" by W. A. Paton and R. L. Dixon, MacMillan. "Whole Dollar Accounting" by F. A. May and A. F. Klingman, Controllership Foundation Inc. "Proceedings of Seventh International Congress of Accountants 1957". "Accountants' Fees and Profits" by R. Sproull, Professional and Trade Books Ltd. "Accounting Trends and Techniques, 1958", American Institute of Certified Public Accountants.

QUEBEC INSTITUTE

Open House Meetings: The program of the Public Relations Sub-Committee on Recruitment includes open house meetings in the Institute Assembly Hall for students in high schools and classical colleges in the Montreal area. The first meeting, for English students, was held on Tuesday, January 13. The French meeting is scheduled for Thursday, February 5.

The sub-committee has also organized a panel of speakers to address classes in the various schools and is now arranging speaking dates for them.

Convocation — March 21: The annual convocation of the Institute will take place at 3.00 p.m. on Saturday, March 21, in the ballroom of the Ritz Carlton Hotel, Montreal. Certificates and prizes will be presented to successful candidates.

Students Society: A large audience attended the third in a series of forums sponsored by the Students Society in December. The speaker was Arthur W. Gilmour, C.A., and his subject "Undistributed Income".

Earlier the society held an "indoctrination day" for students newly registered with the Institute. Sessions were conducted in both English and French.

CALGARY C.A. CLUB

Officers elected for 1958-59 at the recent annual meeting of the Calgary Chartered Accountants Club were D. R. Hagerman, president; D. G. Buchanan, vice-president; D. A. McKay, director; K. H. Coppock, secretary-treasurer. The club now has a membership of nearly 300.

C.A. CLUB OF OTTAWA

On December 11, the club heard an interesting and entertaining address by Hon. J. Waldo Monteith, Minister of National Health and Welfare. Taking as his subject "A Chartered Accountant Looks at Government", Mr. Monteith explained some of the intricacies of his department and emphasized the importance of the existing financial, administrative and political checks and balances, which the public at large is inclined to think of as red tape.

Being the only chartered accountant in the Commons, Mr. Monteith was conscious of being a Daniel in a lions' den of lawyers. He felt the accounting profession had much to offer in present day government and should be better represented in the House. "Think about it," he suggested, "there is another election coming in two or three years."

LE CLUB DES COMPTABLES AGREES DES CANTONS DE L'EST

Le mois dernier, le club tenait sa première assemblée de la présente saison. Le conférencier invité lors du buffet servi au club social de Sherbrooke, était M. Gear McIntyre, sous-ministre du Revenue National, Division de l'Impôt sur le Revenu.

Parmi les autres invités, on remarquait M. Howard Ross, C.A. président de l'Institut des Comptables Agréés de Québec et M. C. D. Mellor, C.A. secrétaire de l'exécutif de cet Institut. M. J. M. Laverdure, C.A., directeur du bureau de l'impôt pour le District de Sherbrooke, agissait comme président de l'Assemblée.

Il y eut aussi une réception civique suivie d'un "cocktail". Le "cocktail" fut donné à la résidence de M. et Mme Charles-Emile Bélanger, C.A.

CLASSIFIED ADVERTISEMENTS

All replies to box numbers should be sent to The Canadian Chartered Accountant, 69 Bloor Street East, Toronto 5, Ontario.

Rates: *Positions wanted, $7.00 per column inch; Positions offered, $10.00 per column inch; Open rate, $17.00 per column inch.*

Closing date is 13th of preceding month.

ACCOUNTING PRACTICE WANTED: Chartered accountant desires to purchase accounting practice in Montreal and vicinity, English or French. Box 842.

PRACTICE WANTED: C.A. resuming residence in Vancouver wishes to purchase small or medium sized practice or to enter partnership with a view to eventual purchase. Box 853.

CHARTERED ACCOUNTANT, with small, growing practice in Toronto, wishes to discuss the possibilities of merging with sole practitioner in similar position. Box 854.

CHARTERED ACCOUNTANT, B.Com., R.I.A., 26, professional and taxation experience, desires position with industrial organization anywhere in Canada. Box 851.

CHARTERED ACCOUNTANT, age 27, with diversified professional experience in eastern and Western Canada since qualification, desires association with small C.A. firm, with partnership prospects. Box 855.

C.A., aged 34 with 9 years professional and 7 years industrial experience, desires challenging position with good opportunity for advancement. Will consider professional or industrial sources. Willing to relocate in Canada or abroad. Box 850.

C.A., B.Com., presently employed with reliable industrial company desires position with professional firm, or one of responsibility in industry. Late thirties. Several years diversified industrial and professional experience. Box 852.

CHARTERED ACCOUNTANT, B.Com. degree, broad professional insurance and municipal experience, requires position, available immediately. Box 837.

QUALIFIED CHARTERED ACCOUNTANT: Female chartered accountant wanted to act as full-time secretary of accounting practice committee of national firm of chartered accountants. Position available immediately. Box 856.

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